FPM-Comment Reducing the Noise

Martin Wirth – 2/2021 dated April 15th 2021

Stock market: Pandemic ticked off

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- Good reasons for record highs and outperformance of value in the first quarter
- Psychology and central banks play decisive roles
- There is no alternative to equities
- Staying ahead of trends on sustainability with FPM Funds Ladon

New highs and outperformance of "value stocks"

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Despite the pandemic and a still fragile economic and political situation, the stock markets in many countries reached new record highs in the first quarter of 2021. This even applies to the Kurs-DAX, which after many attempts over the past 20 years has now exceeded the high it reached in 2000. To avoid panic: this is covered by a different index composition and by the retained earnings accumulated over the last 20 years, which usually amount to 60-70% of the profits generated. So by the total profit of 14 years, if one assumes 30% distribution, and thus with a P/E ratio of 14 actually the total index points. To illustrate the historical dimensions: It took the Dow Jones, calculated as a price index, 26 years to surpass the highs before the Great Depression, and the highs after the post-WW2 boom ended were surpassed 16 years later in 1982. Subsequent years then saw triple-digit percentage returns. Thus, this new high could be very relevant, and one may now look ahead more confidently than in recent years.

Unlike most of the past ten years, "value stocks" were now a clear outperformer. This means that it is no longer only certain parameters of a stock that play a role in the selection, namely growth and stability of earnings, but also the valuation of these earnings, after many low-valued companies had come through the last quarters better than initially feared. Nevertheless, the valuation levels have only partially converged: In order to justify the differences that still exist, one has to carry forward one's optimistic expectations for the companies that continue to be highly valued for a number of years. This is because, in addition to the slowly growing confidence in "normal" companies, speculation around hyped themes has all but disappeared. This can be seen, for example, in the popularity of SPACs, i.e. companies with capital but no business, in which people invest according to the motto: someone will come up with something great. But also with topics that are played up and can be invested in via shares without

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anything relevant to report apart from big words and schemes. Visible in the various aspiring electric car producers who, apart from a few show cars and managers who were only just losers in the declining "old" car industry and are mutating into saviors as a result of a change of employer, have nothing to offer (yet).

Relief at having overcome the pandemic a turning point?

How can it be, and where does the willingness to now gladly see everything in a positive light again come from? Over the past 20 years, the attitude has gone from the "anything goes" of the 1990s to today's "the end is near" mood. Every crisis reached a new dimension in the perception of the markets: from the bursting of the bubble after 2000 to the financial crisis in 2007, the euro debt crisis, the political crises (Crimea, Trump, Turkey, China, trade wars ...) and finally to the existential crisis of the global pandemic. And now it remains to be said: Everything has been survived. Obviously, the robustness of economies, as well as companies in particular, is higher than expected. And in the end, at the beginning of these difficult two decades, we had a valuation problem on the stock markets in the first place. The relief at the prospect of overcoming the pandemic in the foreseeable future is likely to be the decisive factor in now looking at things from more than just a critical perspective. And since psychology is known to drive half of the economy, this could be a turning point to stop just "another low and a lower low..." (Rudi Voeller) and to no longer put safety above all else.

Expropriation of savers by central banks, transfer to owners of real assets

The greatest distortions continue to be found in the bond markets. With interest rates well below inflation rates, the permanent interventions of central banks lead to a massive shift of real assets from creditors to debtors, analogous to a taxation of sound but risk-averse savers with subsequent redistribution to debtors, whether they need it or not. The claim that even without central bank bond purchases interest rates would be where they are today is nonsense: This would mean that central bank interventions would have no effect. In that case, they could be abandoned. In any case, all this is nothing other than a tax on nominal assets, not to mention other effects such as the no longer necessary budgetary discipline of the states or the neglect of the risk appetite of some financial market players.

Unlike a tax imposed by law, you can escape this, and better yet, you can also profit for once as a recipient of the redistribution. Real estate investors have long taken advantage of this, and this also applies to the favorites of recent years on the stock market, the companies that either achieve very stable results, or the fast-growing companies. However, as a result of the strong price performance of these segments, the performance of the shares of the companies that did not meet these criteria suffered: Here, money flowed away into the other segments, with the corresponding impact on valuation differentials.

Pandemic clears the way for expansionary fiscal policy

The pandemic has brought about a relevant change: The states are now no longer just providing cheap money, which they have done for

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the last ten plus years. Now they are also creating the corresponding demand by tearing down all debt brakes. The EU's debt, which is forbidden under the European treaties, is suddenly the highest state policy, and transfer and liability issues are only questioned by so-called anti-Europeans. Compared to the USA, however, this is still a petty matter: Regardless of the administration, things are really getting out of hand there. For many people, incomes have risen during the crisis because the increases in government transfer payments have been greater than the earned incomes that have been lost. This was started by Trump and is now being continued by the Biden administration, but now judged by the media as great wisdom and comprehensive success.

One thing is clear: It is completely indisputable that in a pandemic, a budgetary target that would otherwise have to be met is not the decisive factor. However, things are somewhat different here than they have been in recent decades: From our point of view, the pandemic was only the excuse to abandon the hated budgetary discipline. There are always reasons for this: neglect of infrastructure, education, digitization, and so on. And the central bank ensures the appropriate interest rates, so that the orgy of spending does not put a great strain on current budgets. The fact that every bond must be repaid at some point is generously overlooked: This affects the successors, or one simply lets it be written down once again. This goes well until it doesn't go well anymore. The Greek Ministry of Finance can answer questions on this subject. However, it was always the long-dead predecessors who were to blame.

Valuation of German equities remains attractive overall despite records...

One may not approve of this, but there is no need to suffer more than necessary. German equities in general - after a sluggish period of 20 years since 2000 - often have a considerable risk premium compared to government bonds. Whereas at the end of the 1990s the risk premium was zero to minus three to four percent in some cases, today risk premiums of five to ten percent are the norm rather than the exception. Even if interest rates were to rise somewhat, from a valuation perspective, the circumstances remain crystal clear. At least for those investors who do not face insurmountable regulatory (another government trick) or mental barriers. Those who continue to invest in ultra-low-yielding government bonds in view of the fact that governments, first and foremost the USA, have now switched to distributing helicopter money should explain this in economic terms, we would be interested.

Looking to the near future, i.e. the next few quarters, the outlook has also brightened, as can be seen from the rising share prices. The vaccinations are taking effect, as can be seen from the infection figures and mortality in the countries where vaccinations are already well advanced. And just as important: contrary to the media hype, the vaccine manufacturers' plans have been achieved or exceeded on balance. The stock market is occasionally accused by less competent parties of being largely driven by quarterly thinking. It is clear who is thinking short-term and hysterically here: The stock market certainly does not; here, the emerging end of the pandemic is priced in, even if this will still take several quarters from a global perspective. But the path is clear. Even for the problem of mutations, vaccine manufacturers say they are prepared. And production capacity is gradually becoming less of an issue.

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Thus, the following initial situation is given: Economic normalization, combined with extremely expansionary both monetary and fiscal policies, coupled with an absolutely reasonable and relatively low valuation of equities, apart from exceptions, and a remarkable situation from a technical point of view (rarely mentioned here, but this time it is more relevant from our perspective). The only thing that would argue against equities (in the short term) is the steep rise in recent months. In the longer term and until the general conditions change, there is very little that speaks against equities.

...however, differentiation is advised

In the changed environment since the beginning of the pandemic, two groups of stocks are therefore the first choice: normal to low valued, partly cyclical stocks, which benefit from the stabilization of the economy, the restructurings carried out last year, the decreasing general risk aversion as well as from rising interest rates. In addition, growth companies, as long as the expected growth rates are achieved. However, here the price risks are sometimes immense if targets are missed, so that above-average vigilance is indicated. We avoid stocks that have benefited from falling interest rates but have now reached a valuation that promises only a rather lukewarm return even if interest rates stagnate, but should feel a considerable headwind if interest rates rise. In addition, we are not overconfident and do not bet on companies whose business will come back after the pandemic but whose balance sheets have been ravaged during the last few quarters.

Those who are still worried about the state of the economy should bear one thing in mind: A large part, namely large parts of the service sector, is still in hibernation. If it opens up during the course of the year, demand and employment are likely to shoot up, as is already the case in the USA or China. Whether this will lead to weaker demand in the manufacturing sector, which is favored at the moment, is unclear, but should be kept in mind. At the moment, incomes that have been largely stabilized by government measures are being spent primarily on products, as can be seen from shortages of all kinds. This will not be the case permanently. Be that as it may: For the moment, there is little to be seen that will slow down the positive development.

Shift to a sustainable global economy offers huge opportunities

Looking to the rather longer-term future, ESG will continue to play a growing role. Here, our focus is primarily on "E". In fact, these aspects have also been important in the past when evaluating a business model within our analysis process. However, with FPM Funds Ladon, which has been realigned for a year now, we are going a step further: We are not looking for companies that more or less clearly meet externally defined criteria, whether they fit or not. Rather, the focus here is on companies that make it possible to achieve what is generally considered to be the most pressing problem facing humanity: environmental sustainability. Unlike the widespread view in Germany, we have to admit that we are not among the optimists who think that problems can be solved by bans and regulations without costing a significant part of the prosperity in the richer countries. In particular, bans would probably have the effect that the global middle class and, today, poorer states have no incentive to follow suit as long as resource consumption, e.g. CO2 emissions per capita, is not at a comparable level.

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So we have to try to solve the imbalance in a different way: Namely, through new technologies. This is where opportunities on a massive scale will present themselves to companies in the coming decades. Many things will be capital-intensive, "only" require non-proprietary knowledge or be noticeably regulated. But there will also be companies that develop their own know-how and can leverage this, for example, through partnerships with large companies. The photovoltaic industry has taught (at least) two important lessons: In 15 years, prices have fallen by an unimaginable 90-95%. Photovoltaics is now the cheapest form of electricity generation. At the same time, hardly any company has been able to achieve a sustainable excess return over the long term. Good for mankind, bad for investors. To avoid the latter and to draw a profit for all sides from it is the task when selecting shares and thus when analyzing business models. At this point, a historical comparison: It became clear 25 years ago that the Internet would one day become huge. Many of the most successful companies were not even conceived of at that time.

In this respect, there is a lot to do and observe. The market that will emerge in the next few decades will replace the entire energy industry, for example the oil and gas industry, the utilities, the power plant industry. And that's only part of the opportunity. It is very likely that these prospects will also be exploited by companies that will offer solutions that are still below most radar screens today or are perceived completely differently by the markets. Finding them is the investment theme for FPM Funds Ladon.

Sincerely yours,

M. Wirth

Martin Wirth

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