FPM-Comment Reducing the Noise

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The key thing is to be invested in equity

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

- Favorites switch from cyclicals to quality stocks
- Three reasons for recent developments
- Growth drivers and government measures
- Investment opportunities with CO2 problem solvers

The first half of 2021 was very encouraging

1 The first half of 2021 was characterized economically by a gradually leveling recovery that had begun in the summer of last year. Contributing to the normalization was the containment of the pandemic achieved by vaccination, but also better management of the risks posed by the pandemic. The normalization of the economy was also supported by monetary and fiscal policy to an extent rarely seen. At the same time, restrictions continued, particularly in the service sector. Thus, macroeconomic demand continues to be distorted: Demand for many products is driven by the pandemic, combined with shortages in the supply chain. The situation is different for the services sector.

After strong rally of cyclicals, quality stocks catch up

International stock markets were initially dominated by sectors benefiting from a cyclical recovery and the normalization of underlying conditions, including interest rates. Shares of companies from these sectors recorded historically high outperformance compared with the overall market. This changed in the course of the second quarter. Since then, there have been countermovements, from which both the darlings of recent years and bonds have benefited. In contrast, the winners have had to give up parts of their outperformance since the middle of last year. Three reasons are given for this movement: First, the momentum of recent quarters is slowing for technical reasons alone. Growth rates in whatever respect will be lower than in the previous year, be they in the general economy, corporate profits or inflation rates. At the same time, with regard to the pandemic, the lowest point of infections has probably been reached for the time being. With regard to the longer-term outlook, growth is again expected to be anemic. This would entail permanently low interest rates and favor companies with a stable business model and high-quality growth. Once again, the valuation of different assets hardly matters. Ten-year-old patterns just don't change in a matter of months.

Valuation is the dominant criterion in our investment style. Thus, we have to ask ourselves whether valuation is taking a back seat after a short revival and whether the quality and stability of an investment or the short-term price trend now have the stage to themselves again. To make a long story short: We believe that a change in thinking had not yet really begun. This can be seen in the distinction between risk-on risk-off or reopening trades, where it was completely irrelevant whether a company was interesting per se or whether it just fit into a certain scheme. A perfect example of this is Lufthansa: due to the crisis, Lufthansa accumulated debt and thus reached an enterprise value (consisting of the valuation of equity and debt) that was rarely surpassed even in "normal" times. However, the share fits perfectly into the reopening scheme, regardless of the valuation.

Three reasons for the change of favorites

Moving on to the three reasons given for the change in favorites over the course of the second quarter:

The recognition that momentum is slowing is trivial. The question is what expectations were priced into the shares. In our view, it is now the case that high-quality cyclicals are once again quite expensive, in line with companies that achieve structural growth. In contrast, the "average" companies continue to be favorably valued despite significant outperformance over the past twelve months. Even without growth, good returns can be seen here, which means that the market has assumed a flattening of momentum anyway (as I said, this is all very trivial). In this respect, from a medium-term perspective, there is no reason not to be invested in these segments.

The potentially rising infection figures are happening against a completely different background than was the case with the last waves: vaccines are available on a growing scale. A large proportion of the population groups particularly at risk have been vaccinated. Likewise, based on all that is known, vaccines for the variants of the virus should also be rapidly available. In this respect, the situation is troublesome, but not seriously threatening.

Most important reason: assumption of sustained weak growth with low inflation rates

The last point that remains is the expectation of a return to permanently weak growth. First of all, politicians (and the public) should not be surprised that with an exploding bureaucracy, rising taxes as well as the maintenance of inefficient structures, growth suffers. It's not demographics (yet); this problem will only become a serious issue in the future. What definitely has been and is pro-growth is monetary policy. Unfortunately, however, this has limits: The indebted states are favored, which is obviously the goal, even if an excuse is always given with reference to low inflation. However, on an even larger scale, the owners of real assets such as real estate or stocks benefit, especially if they are indebted, which is the rule rather than the exception: Valuations rise, and at the same time the burdens from financing fall. As a rule, this is the wealthier part of the population. This is financed by savers in nominal terms, who just have to accept a gradual erosion of the purchasing power of their savings. Well done. If the central banks were of the opinion that interest rates would be at the current level even without their intervention, they could stop their interventions. That is exactly what has not been happening for years, so this statement is ridiculous.

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What is not possible is that low interest rates create immediate demand on a desired scale. And since in the years since the debt crisis, countries have also at least pretended to respect debt limits more or less closely, the effects of monetary policy on general growth have been limited.

But: Expansive monetary policy is now being complemented by aggressive fiscal policy

What appears to be changing now: Countries have apparently used the pandemic as an excuse to finally overcome their manageable inhibitions to take on debt. While this was still urgently necessary in the first weeks of the pandemic, today, with the economies largely back to pre-pandemic levels, it is actually no longer called for. Instead of still providing targeted assistance to affected occupational groups, money is flowing from the state to all sorts of uses, without the efficacy being even remotely debated. All of a sudden, the EU can get into debt without the liability of individual states being clear. Even the most tenuous rules are barely scrutinized. Repayment is then supposedly made by the grandchildren of today's decision-makers in 50 years. Since this is mostly financed by central banks, it does not hurt anyone. Germany and the EU are not alone here either: The USA have transferred more money to their citizens over months than many of them could have earned in their actual jobs, and are now wondering about the labor shortage. While the state inflated its debt by more than 10% of GDP, the savings rate among its citizens rose by a comparable amount: at the end of the day, the options for spending the money were notoriously limited. So: the state borrows from the central bank and transfers the money to its citizens' accounts. That, in a nutshell, is how helicopter money is created; you don't need helicopters to do it.

And now there is no need to be curious about how the next orgies will be justified: Climate protection is the joker with which everything can be justified, even if this does not bring the actual goal any closer. With the first transfers from the EU debt pool, Germany and Italy, for example, have financed expenditures that had nothing to do with the pandemic but were already planned anyway. All this is taking place in an environment that still offers sufficient growth potential anyway.

Government measures reinforce the growth drivers that exist anyway

All drivers for economic growth in the coming years (with the exception of supply-side incentives such as the reduction of red tape) are in place. Thanks to falling restrictions, consumption will rise, especially in the service sector. Government spending will increase. Investments postponed in recent quarters will be made up, shortages of goods ranging from construction materials to semiconductors will decline, and international trade will also increase again as restrictions fall. Many companies took advantage of the crisis last year to push through restructuring that had been postponed during the growth phase. The broader use of technologies and the acceptance of digitalization are contributing to growth. Real interest rates continue to be negative, so that even investments with meager returns will pay off (which, incidentally, has allowed inefficient structures to remain in place and thus may have contributed to the weak growth of recent years).

And into this initial condition, the state continues to go full throttle; more than that, the ECB has just increased the inflation target it pursues, thus giving itself even more leeway for further money printing beyond the previous framework. The fact that bonds have risen as a result is not immediately apparent to every market observer.

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Except that one can gamble on short-term profits, the ECB always buys.

For the foreseeable future, therefore, the following should apply: The key thing is to be invested in equity

With a view to the stock market, there is really only one recommendation: The main thing is to be invested. Average companies are benefiting from an economy that is running at a reasonably normal pace, and the relatively low valuations continue to deliver returns far above those of interest-bearing investments. Growth companies are more expensive, but popular and scarce, so that here too the risks exceed the opportunities. Profiteers of low interest rates have now gained further time thanks to market intervention by central banks, and profiteers of rising interest rates are often valued so low on a normalized basis that there is little to go wrong here either. Moreover, at today's valuations, these stocks are a hedge against interest rates that may rise at some point.

How long this will all go well is unclear, but given current premises, one should be prepared for a longer period. In our view, all countries that did not change direction in time have had negative experiences with this policy. In the recent past Zimbabwe, Venezuela or Turkey. The U.S. or Europe are still miles away from these conditions, so this will feel much better than a supply-side regulatory policy in the first few miles. Combined with a stock market whose valuation is okay across the board and cheap in some areas, one can happily go along for the ride. Everything else can be discussed in a few years.

After a significant correction, there is an initial investment opportunity in the CO2 problem solvers

And finally, on the subject of achieving CO2 neutrality: after a massive price movement last year, the momentum here has reversed direction since the first quarter. Some shares have seen significant price declines. In this environment, FPM Funds Ladon has performed solidly and continues to post a pleasing price gain for 2021. There were two reasons for the sector's price weakness: First, valuation was stretched given the long-term nature of many projects and the technical and economic risks. Which, incidentally, proves that valuation does matter. Secondly, the EU held out the prospect of extensive support measures. Since the details are still open here, except that the volume will be large, decisions have naturally been postponed for the time being. This in turn means that in various cases the expectations for 2021 cannot be met. Which on the one hand is difficult when valuations are high, on the other hand is not particularly relevant when you look at the period over which these companies can grow, provided their products and services are useful. We see this as an opportunity to enter the market.

Sincerely yours,

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