FPM-Comment Reducing the Noise

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Opportunities for 2021: "Economy doping" to help mitigate the effects of the pandemic

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- 2020 in retrospect: Stock market records despite poor outlook
- Starting position for the new year different from previous recessions
- New debt and possible effects: Our core scenario
- Profiteers of a new public consensus

The markets in times of the pandemic

The year 2020 will undoubtedly go down in history, even if not in first place, in terms of developments on the capital markets. Briefly summarized, last year broke down into four phases:

- A beginning characterized by gradual economic stabilization accompanied by growing uncertainty due to the spreading pandemic,
- a panic caused by complete lack of clarity regarding the hazards resulting from the pandemic,
- a calming down and normalization after the containment measures also showed success outside Asia and the large but still definable extent of the dangers became clear,
- and finally, a renewed substantial increase in the number of infections, which, however, were no longer taken so seriously because of the vaccine that was now available.

The development on the stock markets followed suit: After flight to safety was initially the order of the day, shares were bought back as the rational assessment of the situation gradually became clearer, and business returned to normal more or less quickly after the reopening.

Stock market records despite pessimism and labor market worries

The very big winners were the shares of companies that were actually able to drive their business forward as a result of the pandemic, first and foremost digital companies, but also companies that offer specific products or services and even saw increased demand under the general conditions. As the second group, the shares of many manufacturing companies were able to largely compensate for their initial losses following a strong recovery and reached a level that was more or less the same as before the start

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of the pandemic. This put them on a par with the stable companies that had previously been highly rated, but which delivered only manageable share price performance in the further course of the year. The losers were the companies whose business requires personal contacts and their "suppliers". As this part of the economy is labor-intensive but often not listed on the stock exchange, it was constantly the focus of public interest, far beyond its significance for the capital markets. This is probably also the reason for the confusion of many observers, who were unable to reconcile new record highs on the stock markets with poor economic and labor market data.

Where are we now at the beginning of 2021?

The availability of a vaccination is, of course, the turning point par excellence. As the situation stands today, it means the following:

- Over the course of the year, the situation will gradually normalize.

- Accordingly, the behavioral patterns that were normal before the crisis will also return.

- The sectors that are suffering particularly from the pandemic today will return to more stable ground.

- At the same time, central banks will keep interest rates low and governments will keep debt levels high. As long as there is no all-clear on a broad front, experience shows that none of the political players will venture too far ahead and prefer to stay "behind the curve". Moreover, this is much more pleasant for everyone in the short term.

- Thus, coming from a low base, the year will be characterized by high rates of economic growth and corporate profits.

- Due to the underutilization of the economy, significantly rising inflation rates are unlikely. But even at current levels, they do not justify the current extremely low interest rates. As the economy normalizes, inflation expectations will also move higher.

- Investments benefiting from falling interest rates could face hard times. Conversely, companies that have suffered from low interest rates are showing signs of improvement.

- The extreme valuation discrepancies between the various market segments, which have already narrowed in recent months, are likely to narrow further.

- The fundamental driver of this development is also likely to be the efficiency programs launched in response to the slump in business caused by the pandemic. In the years following the financial crisis, it was easy for many companies to achieve good profit growth thanks to a stable economy, falling interest rates or growth markets such as China. This changed in the last five years, during which a broad-based weakening of cost discipline, coupled with uncertainties in global trade and burdens from technology disruptions and rampant governmental regulatory mania, have led to significant headwinds.

- Thus, cyclical and structural drivers could reverse the relative growth dynamics of earnings. Falling costs, rather than falling interest rates, could lead to earnings surprises.

A completely different recession

From our point of view, it is quite important to understand that this time, unlike the last recessions, the economic slump had NO economic causes. This means that this time there is no

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oversupply of real estate, production capacity of any kind or bad debts threatening the existence of ailing banks. These problems required a more or less long period of time to work through. Now there is nothing to work through, except that broad immunization must be achieved.

Paradigm shift when it comes to sovereign debt?

On the contrary, the restrictions have led to consumption cuts and forced savings for the past year. Many governments partially compensated for the loss of wages, some even more than that. Accordingly, with the easing of restrictions, it is likely that these savings will first of all have an impact on demand. That's not all: Even if the economy gradually returns to normal, many countries will stick to high levels of new borrowing, having acquired a taste for it and obviously having broken the dams thanks to the pandemic. The central banks have become the enforcement agents of the governments and are standing by to finance the rising new debt. This seems like something out of the cabinet of horrors of a regulatory politician. But it has now become reality. Instead of a balanced budget, it has become a political dogma to achieve an inflation rate of 2%. And it has already been anticipated: As a precaution, it is stated that 2% is to apply over a long period of time and, to that extent, the last ten years are to be compensated for by overshooting inflation rates beyond the 2% target. Even if this does not turn out to be the case in the end: The direction has been set, and one should be prepared for it. The fact that there has been no lasting positive experience with this, either in the past or in other regions of the world, is being ignored. The only question that remains is when this will become obvious in the markets. Experience shows that accepting a negative real interest rate at a historic record level for years by investing in bonds will not remain a permanent condition.

There is little to be gained in real terms. At the end of the day, the economy is doing better thanks to governmental doping than it would be without it. We will see when the effect wears off. The results are unlikely to be any more convincing across the board than they were in comparable cases in the past. But one thing should be kept in mind: In this period, one should not have investments whose prices and/or returns are fixed and whose success depends on the willingness to take on aggressive debt, but rather companies that control their prices and that have their finances under control even under changed conditions. After all, experience shows that the most likely outcome of the current measures is stagflation spreading over the next few years. Even if inflation rates are unlikely to reach exorbitant heights. In stagflation, we should expect valuation parameters to decline overall and, more importantly, to narrow, which would mean substantial effects on the performance of individual market segments given today's ranges. So much for our core scenario.

Bright times for greentech shares

There is likely to be one exception: "green" investments are likely to benefit from government support to an extent that has not been seen in a long time. For one thing, there is a public consensus to achieve a whole set of goals quickly and obviously without major budget constraints. This can make sense if greater damage can be avoided by not taking appropriate action. Thus, states will regulate, subsidize, and support research into new technologies. Companies will use their own measures and products for marketing purposes, among other things.

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And at the same time, this effort will lead to economically surprising results. The products and processes that will play a major role in the next few years are often below most radar screens today. What is possible is shown by the cost development of photovoltaics: Coming from 40cts/kWh 15 years ago, prices today are sometimes less than 2cts/kWh, making PV electricity the cheapest source of electricity. Albeit without taking into account storage costs.

In addition, from a stock market perspective, there is the possibility that money will flow into this sector: Due to investment regulations, self-imposed goals of investors, positive prospects of companies in this sector, and ultimately by capital chasing performance. ESG regulations have tended to be viewed as criteria to be met in whatever form. Sometimes through "greenwashing". In the future, the big driver will be that external costs (usually environmental costs such as global warming, insect mortality, or inadequately disposed waste) caused by economic activities will be integrated into the total cost of a product or service. And this will have significant consequences. On prices, on costs, on processes, on products. CO_2 pricing is just at the beginning. How things will develop in detail remains to be seen. However, one should not only consider this epochal change in one's investment decisions, but see it as an investment topic in its own right.

Outlook and positioning

Looking ahead to the next few months, the German stock market as a whole is fairly valued despite a record high. Despite the underperformance of recent months, stable and interest-driven stocks remain highly valued. Other segments, in particular stocks whose earnings performance has not surprised positively, in turn tend to be low. Cyclical stocks, provided their earnings performed well, are no longer cheap in any case, which has changed compared to previous quarters. Main drivers of the stock market were therefore earnings surprises. Since surprises are characterized by the fact that they are surprises, we prefer to bet on those stocks whose potential is higher under normal circumstances than it is at the moment, but also on stocks whose quality is not reflected by the current prices - despite or even because of the lack of surprises in recent weeks. From today's perspective, these stocks are well hedged and have a risk premium that should be more than adequate. If (positive) surprises were to be added, all the better.

Sincerely yours,

Martin Wirth

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