FPM-Comment Reducing the Noise

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Investment prospects from a value investor's point of view with a reminder for dictators

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- Relatively smooth start to the year for FPM Funds thanks to value orientation
- Geostrategic considerations and why China could become the bigger problem
- Inflation likely to be permanently higher than reflected by interest rates
- Recession largely priced into equity prices
- Opportunities in cyclicals and massively fallen growth stocks

1 The start to the year was poor, but not disastrous

After a good start, the first quarter was increasingly unpleasant, caused of course by the war in Ukraine and the associated economic and inflation risks. After a moment of shock at the beginning of the war, market participants made an attempt to adjust to the new circumstances. This is anything but easy, as things and assessments are constantly changing, including those aspects that are highly relevant for the capital markets. The situation is further complicated by the fact that the global economy is also far from having overcome the problems associated with the corona pandemic crisis. It is therefore astonishing at first glance that a good part of the price slump has been made up more or less quickly: The dimension of the problems is different than during the banking crisis or the EU debt crisis. However, the restrained reaction becomes understandable against the background that, on the one hand, many shares were simply not too expensive and thus had a solid risk premium, which is now a buffer. On the other hand, it is relevant that the alternative investment options, primarily liquidity and bonds, do not look particularly attractive in view of the massive increase in inflation. That leaves real estate, which is rather expensive in many countries, or gold and bitcoin. Gold is at a record high, we have no opinion on Bitcoin (at least none that we will announce here). So in the end, stocks don't look so bad in relative terms, despite the devastating conditions.

FPM Funds with significantly below-average losses thanks to value orientation

Despite losses, FPM Funds performed significantly better than the benchmark indices, to which we now always have to refer for regulatory reasons. On the one hand, we remained true to our investment philosophy of focusing on low-valued stocks with a comprehensible business model.

Of course, this also includes stocks that are frowned upon by most investors due to certain characteristics, for reasons that we do not consider appropriate. First and foremost among these are companies in the defense industry, which are perceived by the public to have most of their customers in states where human rights count for nothing. Why we see this differently and why we regard these companies as essential to our way of life probably does not need to be explained anymore now. And perhaps to point out that the overwhelming majority of these companies' sales are generated in countries with a societal order similar to that in Germany. The same applies to companies that are essential for the production of food: Why companies that make products for oligarch households have a better ESG ranking than companies that provide food for hundreds of millions of people is probably something your trusted rating agency, which collects a lot of money for these findings, will be happy to explain. We don't get it. We are not fundamentally invested in these companies. But now we were, as the valuation was at ridiculous levels in some cases. The dramatic events, as well as their expected impact over the next few years, led to significant upside in the stocks of these companies, which in aggregate limited the losses at the portfolio level. The next downgrade is probably coming soon as well: after all, these are war profiteers now.

In contrast, companies that rely on a functioning added-value chain experienced headwinds, as did growth companies that were seen euphorically just over a year ago but are now suffering from disappointed dreams and rising interest rates. Comparatively stable were once again the companies with a qualitatively above-average business model. This happened despite their rather high valuation, which should actually suffer when interest rates rise. In this respect, under normal conditions, this segment is the only one in which we can see an overvaluation. After all, as far as the stock market in general is concerned, anyone who thinks we are now at the start of a bear market has obviously missed the last few years in many market segments. This view of things is obviously based on looking primarily at the indices as well as the overall market valuation. With the exception of stocks with a clearly above-average quality, many stocks are substantially, in some cases mile-wide, below their highs of the last years. Thus, in principle, today would be a good time to increase one's investment in the stock market. However, times are not normal, and therefore we too need to think about how to deal with the situation.

Even as non-geostrategists, we are forced to evaluate the changed situation

It is well known that the assessment of future developments has always been difficult, but at present it is even more complex. In the following, we present how we see the situation and what conclusions we draw from it for our investments. We do not claim to be right, but we do our best. And: we must have an assessment of what is happening. Not having an opinion would be highly negligent in this environment. Even if we are not geostrategic experts. However, if we take the capabilities of the German intelligence service as well as those of some advisors to the (former) German government as a benchmark, then any amateur can give it a try. We have to make our stock selection (more precisely: prior to that, an idea of an optimal asset allocation whose parameters describe the preferred stock segments) on this basis and cannot pretend that the situation does not exist.

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Raw materials scarcer and more expensive, but likely to remain available

So what are our expectations? It looks like Russia will not win this war. Russia will be increasingly marginalized from the West as long as the regime does not change. Worst Case: North Korea. The biggest danger for the Western countries, but also for the global economy as a whole, is the declining supply of raw materials, and for Germany, of course, of gas. The prices of all these commodities have risen, which the Europeans and the Americans are more likely to bear than many other countries. The beneficiaries are commodity-related companies and companies that have pricing power in their value chain, which we perceive to be an astonishing number of companies. Here, the shortage of supply has a positive effect. The losers are consumers and more consumption-related companies, presumably in the area of spending that can be shifted. Outside the wealthier regions, these adjustments to higher prices are likely to be more difficult. However, a complete elimination of many commodities would cause dislocations everywhere. The danger is looming, but it is becoming somewhat smaller with each passing day as alternatives are developed. As a result, the problem still remains. It is also not as hopeless as it first appeared: in part, production can be increased, other agricultural crops can be grown, and in part, the use of the harvest can be modified. Moreover, in our opinion, the probability of a cessation of raw material supplies from the Russian side is low, because Russia obviously needs the money, not to finance the war, but the structures in Russia: from the machinery of oppression to pensions, presumably also to compensate for the losses of the (newer) oligarchs, who may not have wanted the war, but accepted it in order to have their peace. If the godfather, in analogy to the earlier Sicilian experience, stops delivering, then he is at high risk. And thus he will not turn off the gas. There remains, of course, the risk of a European embargo.

China could become the bigger problem in the medium term

Perhaps China, not Russia, is the bigger problem in the long run: The country has an autocratic government that is increasingly hostile to the West and is economically many times more important to Western companies than Russia. After the experience that ignoring the facts increases the problems instead of eliminating them, a clarification of China's positioning is due in the next few years. The outcome is open. The hybris with which China's own Covid-19 policy was seen as superior to that of the rest of the world and especially to the West is remarkable in view of the current situation. However, China thereby gave a sign of how it sees itself positioned in the competition of systems. And one can now see how it really looks.

Perhaps China – or more precisely, the Chinese leadership – respects a tougher and more direct stance rather than the fact that while most countries do not act aggressively against China, the "Western" way of life is spreading all over the world, undermining even the autocratic states from their government's point of view. For whatever reason, many autocrats accuse the West of being wimpy, as exemplified by the homosexual rights that Putin and his church patriarch are bashing. Apart from everything else that could be said about human rights, this is, like many other things, a fundamental misunder-standing of the situation in the world. Minority rights are not only enforceable in free societies. They are demanded and become reality above all

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in rich societies. As can be seen from Maslow's pyramid of needs, autocratic countries deal with levels below self-fulfillment. This has nothing to do with wimpiness, but economic strength. And therein lies the problem for autocrats: The same economic strength that enables diversity of opinion, freedom rights and, for example, creativity, is also the basis for political and, especially in these days, once again sought-after military strength. Reminder for dictators: It is better not to attack countries where the CSD is celebrated. Exceptions confirm the rule. And because the Western model is more attractive to most people than what the autocrats have to offer, their power is undermined. That leads the autocracies to conflict and war, openly and covertly, with real weapons and in the cyber universe, in the media, etc. The West has looked on and tolerated this for decades, and cared about all sorts of other things. With the invasion of Ukraine, which was obviously lost to the West from Russia's perspective, the Rubicon was crossed.

From all we can see, the size of the Russian army is roughly comparable to that of the economy of East Germany: large from a distance, but a pseudo-giant when measured against assumptions. A nuclear war excluded: This war will ruin Russia, and not the West, regardless of the fate of Ukraine. What lessons China learns is an open question. Many autocrats in the world will have to live with the fact that their godfather in Moscow will no longer be able to play the same role as before. For most people, this is a welcome message, although not for all regimes.

Unclear if we are facing a change in world order

There is one thing I cannot refrain from saying: Concerning the repeatedly heard argument that the U.S. also violates international law with its wars of aggression. Yes, they do, and they do so in cases where autocrats hide behind international law and at the same time violate human rights in an unfathomable way. In doing so, U.S. critics place Assad, Saddam Hussein, and Milosivic on a par with the Ukrainian president. It is hard to fall lower than that. The problem is that the UN sees in international law the way to prohibit wars of aggression on countries, which leaders who violate human rights use for their own personal defense. This leads to a situation where the UN as an organization is endangered in its existence: it makes it easier for potentates to abuse their rights against their own people. How this works was demonstrated in the second Iraq war: The USA tried to build a case that would justify a war of aggression against Iraq. As everyone knows: wrongly from the point of view of international law. However, critics of the U.S. seem to accept that torture has been used in Iraq, Kurds and Shiites have been persecuted, chemical weapons have been used against its own population, human rights have been broken by any means of potentate art, without any critic being able to point out a better solution, except for the always well-sounding and mostly ineffective negotiation.

The spirit in which the UN was created has long been destroyed by the violators of human rights. Thus, the question arises here, too, what the world will look like in a few years in this respect. Whether an organization is worth preserving that in seven years issues five times as many resolutions directed against Israel as against the rest of the world combined? Among other things, as the only country in the world where, according to the UN, women's rights are violated. This question does indeed arise. In this respect, it is not far-fetched to imagine a different world order.

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Inflation likely to be permanently higher than depicted by interest rates

Back to the more immediate economic aspects: Even without the war in Ukraine, the inflation rate had already risen to levels not seen in a long time. There were several reasons for this: Fiscal policy, especially in the U.S., was very expansionary, going beyond what was needed to offset the panemic effects. This was accompanied, especially in the EU, by further extremely expansionary monetary policy. Both can be stopped by the usual measures. However, there were two additional problems on the supply side: the corona pandemic crisis with its impact on production volumes and supply chains and, at the same time, a commodity industry that has been underinvesting for years, to which, of course, misunderstood ESG measures geared at short-term effects also contributed. And now the Ukraine war has been added to the mix. It should be extremely difficult for central banks to find an appropriate measure that would be proportionate to the level of inflation. The overshooting beyond all expectations came largely from the supply side. In this respect, one should be prepared for the fact that the inflation rate can also be slowed down by destroying demand. In addition, an annualization of price surges can be expected at some point in the future. The big question then, however, is whether a wage-price spiraling will have occurred by then. It will not be possible to avoid this entirely. In this respect, it can generally be assumed that the figures will fall again, but will probably remain at a higher level than in the past. This development will be reinforced by the fact that particularly positive underlying conditions of recent years will cease to exist: Even in the best-case scenario, globalization will not continue at the same pace because it was already well advanced. On the contrary, various economic sectors could become regionalized again. In addition, there will be an increasing need for capital for the transformation of the economy toward climate neutrality, a substantial need for national defense and perhaps later for the reconstruction of Ukraine. This can really only lead to higher inflation rates. Where exactly is unknown, but the level is likely to be significantly higher than what is still being implied in the interest rate markets.

Recession is possible, but largely reflected in prices

In sum, this means: The economy will suffer, perhaps to the point of a recession. The adjustment of the markets to the new circumstances – provided no gas embargo comes into force – is advanced, but not yet complete. The capital needs of the economies are immense: energy transition accelerated, new procurement structures (Intel alone will apparently receive government support in the tens of billions to build its semiconductor factories in Europe), dealing with the pandemic crisis, supporting and expanding military forces, supporting Ukraine, and if one day Ukraine is admitted to the EU, this will require capital in another dimension. Thus, it is completely unclear how interest rates can sustainably remain at today's levels without investors in these markets suffering harsh real losses. The clinging to "safe" bonds and liquidity is probably also just a reaction to the fact that at the moment it is still unclear how things will develop. Better safe than sorry, and that means giving up a few percent of one's assets in real terms, annually that is.

Opportunities again in cyclicals and massively fallen growth stocks

We, on the other hand, tend to see the opportunities: Various, more cyclical stocks are valued at recession levels, if not lower. They are

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therefore already pricing in further dislocations, at least in part, even if the companies are affected by supply chain problems for a transitional period at most. In addition, various growth companies have suffered a massive drop in share prices and are also valued low as a result. We tend to avoid companies that benefit from low interest rates, e.g. due to their above-average debt, as well as companies that are considered to have above-average quality. In sum, equities are cheap again. The risks arising from an above-average dependence on China can either be avoided or accepted in the form of a low valuation. And ultimately, one should consider where inflation, which is seen as a threat, is coming from: Through price increases, which are primarily enforced by corporations and will benefit shareholders as opposed to bondholders. If things go as they did in the 70's, the most recent period of high inflation, low valued normal stocks will be solid winners over the next few years. The losers back then were the Nifty Fifty. In our eyes, their successors should be avoided in the next few years.

Sincerely yours,

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