FRANKFURT PERFORMANCE MANAGEMENT AG

FPM-Comment Reducing the Noise

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Where does the road lead once shortages and crises are overcome?

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

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In the first quarter of 2023, the previous year's losses on the German stock market were partially offset. In this context, large-cap stocks fared more favorably than small and mid-cap stocks, which had to make up for higher losses. In general, however, the development was not compelling at first glance given the news situation.

The war in Ukraine continues, geopolitical uncertainties have not abated, inflation seems to be getting out of hand, and at the same time more and more signs of economic weakness are emerging, with the U.S. leading the way. Accordingly, many sentiment indicators are at low levels, so the development took place without much enthusiasm from market participants.

Defying inflation with stocks

On the other hand, and from our point of view as value investors, this was the decisive factor: equities are generally valued lower than they have been for a long time - not all of them, but a great many. And while companies across the board have been able to pass on cost increases to customers and thus keep the real damage from increased inflation in check, this has not been possible with nominal investments as well as with investments in real estate. Given the general conditions, it is no wonder that enthusiasm is not overflowing, quite the contrary. However, you might also ask yourself when you want to invest at all: You can buy lots of companies at a more or less significant discount to their net asset value, even if you don't believe in the sustainability of their current profits.

We certainly agree on the latter. Fortunately, the shortages created by the pandemic and later the energy crisis are finite. To that extent, excess returns will disappear again, starting with freight rates, energy prices, car prices and the like. Only: Who believed that this could go on forever?

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Even if the earnings estimates were still based on an extrapolation, the valuations of the companies showed that no one really dared to believe this.

The exciting question now is whether the focus will return to companies with a stable business development that is rather independent of the economic cycle, but which still tend to be fully paid, or whether people will accept cutbacks in business quality and go on the great bargain hunt. Since the market obviously prefers to look at the trend in profits rather than what one has to pay for them, one could tend toward the first thesis. However, this market area is now much smaller than in previous years, after some former high flyers in particular were massively punished. In this respect, the distinction today is somewhat different than it was in the last few years. Favorites could rather be those companies which are considered boring, reasonably valued, which do not arouse much imagination, but which are also not substantially undervalued and in the best case free of scandals. And on the other hand, likewise solid companies, but whose earnings power can fluctuate significantly within a few quarters and for which investors fear price losses under these circumstances. In short, on the stock market 1+1+1 is worth more than 2+0+2. This means that investors would rather forego earnings in exchange for peace of mind.

Our investments cover both of these categories, with a bias towards low valuations. On the other hand, we continue to be uninvested in top quality (at least companies perceived as such) for valuation reasons.

Our thoughts on inflation, interest rates and valuations

What drives us? In addition to looking at the sustainable earnings strength of a company, which is precisely not reflected by quarterly results that fluctuate more or less in the short term, one cannot neglect the influence of the permanently changing underlying conditions. Since the Covid crisis, these fluctuations have reached dimensions previously unknown. Therefore, they also have an impact on our investment decisions, and hence now our view of things (which may or may not be shared).

First, inflation: it is obvious in our eyes that the peak has been clearly passed, that inflation is on the retreat, and that these developments will run through the entire value chain. The laggards are collective bargaining, which will ultimately cost companies money, which is obviously already factored into the markets' implicit expectations. After inflation rates roll over they will probably fall significantly in the course of this year and the next. However, no one can seriously claim that there will be a comparatively narrow corridor as felt in recent years. And it is more than likely that inflation rates will remain in a range that is too high for central banks for longer, at least if you want to follow their statements.

This has implications for the valuation of companies that are dependent on the level of interest rates, first and foremost real estate companies in the negative sense, banks and insurance companies in the positive sense. This also applies to companies where, for example, retirement provisioning has been inflated in recent years. Here, one should not assume that the old interest rate levels will be reached again, especially not after the unpleasant experiences with regard to the distribution effects of inflation, which can be read in any textbook on basic economics, but which were obviously not really appreciated as reading in the decisive places.

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This will therefore lead to an increasingly restrictive monetary policy for the next few quarters after the damage done has to be compensated. However, and we are probably in the majority camp here, monetary policy will tend to loosen again as soon as possible albeit not to the same extent as in recent years and not before next year.

Until then, in addition to the slowdown that is underway anyway, the fading of the post-Covid boom and the decline in scarcity prices will be headwinds for companies. In Europe, at least the absence of the Armageddon of the energy crisis has created a slight additional tailwind that may help avoid recession. The distortions were already partly borne last year, as can be seen from the full stop in the chemical industry, so that the height of the fall has been significantly reduced. And what was calculated at the time has turned out to be far too pessimistic from today's perspective. The rise in gas prices, for example, is costing Germany less than 0.5 % of national income compared with the lows of a few years ago, which is so little that policymakers are not even seriously considering Germany's natural gas reserves, which would cover most of the country's gas needs until the "energy turnaround" is finally complete.

A look at America

Instead, things are looking less encouraging in the USA this time around. This, too, is more of a disillusionment that follows excessive monetary policy and the issuing of helicopter money to citizens. In the U.S., too, the wisdoms of economics are only gladly followed if they are politically communicable, i.e., if they please the citizen. And at some point, this comes to an end. But here, too, it is relatively simple: Once the excesses have been reduced, things move on. And the excesses this time were very manageable compared to the times of the financial crisis: Only a few percent of national income given away, instead of several years of redistribution like before the housing and banking crisis. In this respect the world should look more "normal" again in a year's time: Employees will be easier to find, the economy will get used to the nominally higher interest rates, which are not high at all in real terms, and companies will have adapted to the changed conditions in their markets. Anyone who still does not believe that this is possible within a reasonable period of time has not drawn any conclusions at all from the extreme conditions of recent years.

Banks in the focus of negative scenarios

If all this seems plausible, which it just should after the experiences of the last decades, there still remains a wild card for the bears (besides war, geo-crisis, climate change, a comet impact):

Candidates for a new Armageddon are once again the banks. The following can be said about this without giving the final guarantee: the comparison with the financial crisis of 2008 is completely absurd, and this is particularly true for European banks. (Some) banks are suffering from an unwillingness to adapt to the changed environment and were ultimately poorly managed. The sooner this brought a bank to the brink of ruin the better in hindsight. UBS from 2008 or Deutsche Bank from 2017 are just examples of how business models were transformed when things could no longer go on and the neglect of business practices was no longer tolerated. The last one to bite is the dog, and in this case it was Credit Suisse, which after all managed to slide into ruin in a very short time as a solvent bank with weak earnings but without huge operating losses. Cause: complete loss of confidence. If Volkswagen no longer gets

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any steel delivered or Aldi no longer gets any food, then these companies will also go under. The only difference is that the trust there does not vanish into thin air in the shortest possible time. A terrific lesson for all other market participants. And bad luck for Credit Suisse, which had previously been the one-eyed man among the blind. Life punishes those who come too late (Gorbachev).

The following is all I have to say about the U.S. banking crisis: What was handled there as a business by some banks, which for unclear reasons are no longer subject to proper regulation, is not intended to be so according to Fundamentals of Banking Management Part 1: Investing short term deposits in long term government bonds and hoping that the different yields will bring the big payoff. Until the next inversion of the yield curve. For once, some good news: In Europe, this is no longer conceivable at this level.

What is conceivable or even a fact is that investors in government bonds lost a lot of money last year. The amount that was a burden on banks' balance sheets at the peak was more than € 600 billion. A lot of money, but only a fraction of the equity. In the meantime, it has fallen again significantly as a burden, especially in the U.S. and the U.S. dollar. This has not stopped depositors from withdrawing their money, essentially unsecured deposits, from Silicon Valley Bank, since the benefits and returns of holding deposits with an insolvent bank are completely asymmetrically distributed: There is no additional benefit compared to an account held at a stable bank. In the case of other banks these burdens from the rise in interest rates were much lower or were refinanced on time. In this respect this is on the one hand an individual problem. On the other hand, however, and this is much more relevant, this has nothing whatsoever to do with a financial crisis like the one in 2008. It is rather another consequence of the misguided central bank policy of recent years, albeit a consequence that does not lead to insolvency, but could essentially cost some banks a portion of their earnings - or has already done so.

European banks are better than their reputation!

From our perspective, the situation is actually the exact opposite of what is served up in the media: Thanks to years of pressure from regulation, additional charges and low interest rates, banks are perceived as notoriously low-yielding. In many ways, we are at a tipping point here and have probably already passed it. Roughly outlined: Regulation will obviously no longer be tightened significantly, bank levies (nonsensically not even deductible for tax purposes in Germany) will fall, and most importantly, the normalization of interest rates will make normal banking profitable again, on both the deposit and the asset side. Unlike in 2008, it is obvious that banks have a clue what they have on the balance sheet and are documenting it. Unlike their supposed observers, who fabulate wildly about risks without even once taking note of simple facts. Events such as the demise of Credit Suisse undoubtedly weigh on sentiment and the willingness to invest in the sector. But it should also be certain that other banks will benefit from this unraveling. The demise of Credit Suisse was ultimately the result of a decade in which the bank earned nothing, unlike its employees. If this serves as a blueprint for how not to do it, then there is something good about it. Consolidation has never hurt any industry, and it will be no different here.

What does the market offer?

Short-term uncertainty, high but falling inflation rates, a weakening economy with the potential for

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recession, at least in parts of the economy, are the framework for the coming months. At the same time, sentiment and valuations are where one might expect them to be in a recession, as opposed to still current earnings expectations.

Shares of even rock-solid companies are now trading at significant discounts to their substance in many cases, to the extent that the recession has just been priced in and the earnings power that can then be expected is seen as permanent. At the same time, dividend yields are at record levels. This is not necessarily a reason for many investors; as is well known, dividends can also be cut or cancelled. What is more relevant however is that ratios such as dividend yields in relation to P/E ratios are at levels that were only surpassed during the global financial crisis and the pandemic crisis.

More and more companies are starting share buybacks due to sustained low valuations, which in recent years have often been seen as a bankruptcy of entrepreneurial idea creation. In this respect, there is obviously a point at which one cannot resist after all. From a mathematical point of view, all this is quite easy to understand.

Without going into details: Many companies have valuations according to a wide variety of criteria that price in completely different, and indeed worse, underlying conditions than are likely from today's perspective even if one does not want to regard the current earnings estimates as a sustainable basis. In our view the reason for this is that in recent years many investors have simply capitulated to the volatility of the stock markets and preferred to retreat to nominally stable investments. Additional regulation, but also trading according to more or less trivial algorithms instead of the most comprehensive understanding possible of the complexity of the economy, may have exacerbated the volatility ...

The fact that private equity investors pay twice as high valuations for the same investments as those demanded on the stock market ultimately only makes sense if they can procure the capital much more cheaply than is the case on the stock market. As long as interest rates were low, these investments could be sorted into the range of volatility-free investments by the financial investors, which was then also useful for risk assessment. Pure accounting that has nothing to do with economic reality. This was similar with bonds and especially with real estate. Here, too, one can see the differences between the fungible (stock market) and non-fungible markets: While transactions with real estate are carried out at significant but understandable discounts (10-15% are regularly quoted) to the former peak prices, real estate stocks were literally slaughtered. Price losses of more than 70 %, which would represent a discount on the debt-free calculated real estate of 40 %, with simultaneously rising construction and replacement costs: this is largely senseless. And not to mention the many "unicorns" that are practically turnover-free but valued in the billions: The great returns have then often only been on paper, but presumably properly audited. Here, too, things have obviously changed.

The turnaround in interest rates has probably hit like a fox in a henhouse. Obviously, it's not just the generally subdued mood that's getting to investors. By all accounts, the interest rate turnaround is also an issue that has damaged the solvency of many investors. In this respect, it is clear that risk appetite is reduced for the time being. And this, unlike recession fears, is what we see as the main reason for the modest valuations and, in our view, obvious large investment opportunities.

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What appears positive in this light is the fact that many companies, while not among the darlings of the investment community in recent years, have performed stably to decently in this difficult environment. Share buybacks have already been mentioned, but obviously there are also valuation levels at which, interest rates or recession aside, people no longer want to part with investments. And prefer to wait until the smoke clears. If there are setbacks buyers will quickly come out of hiding as long as the valuations are not excessive. In this respect, we believe that there is a lot to be said for the fact that we are somewhere in the area of the bottom for many stocks. And that these stocks will perform when things develop the way they always do: slowly forward.

Sincerely yours,

M. Wirth

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