FPM-Comment Reducing the Noise

Martin Wirth – 1/2023 dated January 19th 2023

Check off the year 2022 and look ahead!

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The year 2022 is history, and the vast majority of market participants should be happy about it. With most asset classes, one had the best chances of losing money. However, the differences in performance were massive, with the result that many rather manageable price declines are likely to be temporary, while some investments may have brought permanent losses. This makes the difference in the longer term: Are you still in the game, or have you been knocked out?

Looking back at the market ...

On the German stock market, the few winners were the companies that benefited business-wise from the outbreak of war and previously had a low valuation, as well as the companies that benefited from rising interest rates, first and foremost of course banks and insurance companies.

The majority of shares recorded noticeable double-digit losses, even if the development of the actual business was solid. On the other hand, the former high-flyers, especially from the growth sector, were hit particularly hard when high valuations met with weaker-than-expected business developments. In such cases, it was possible to experience a share price loss of 50 to 90%, in some cases without the business model of a company being fundamentally impaired. Here, the effect of value investing was on full display: Nothing is so great that you should pay any price for it. However, we now see greater opportunities in this area again, to be clear.

... and on the FPM Funds

Last year, the FPM Funds recorded losses in line with the various indices. The range of performance of the investments was significant, from significant gains to significant losses. Furthermore, from a relative point of view, the funds were hurt by the comparatively good performance of stable

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equities, which we have been avoiding for years in view of their high valuation. The performance of a number of second-tier stocks was also poor. Although their business performance was decent, many market participants sold them in order to reduce risk, mostly only because they were second-tier stocks. In relative terms, on the other hand, it was very helpful that the formerly expensive growth stocks and the profiteers of low interest rates, such as real estate companies in particular, were only represented in the portfolio to a below-average extent: In some cases, the losses there were very heavy. All in all, share prices fell and so did valuations, with the result that portfolios are now even more attractively valued than they were a year ago.

The big picture: Putting it into context

Looking at the general framework, the losses on the German stock market are even almost bearable. In the past, far smaller problems have caused significantly higher share price losses and, as I said, a whole series of not exactly small companies have even been able to record share price gains. In our view, this clearly speaks for a sustained low valuation of the asset class "German equities", which has obviously been abandoned for good by many investors last year, i.e. until the next strong performance of the market.

Among the obstacles are first and foremost the war in Ukraine, then the whole combination of rising energy and food prices, skyrocketing inflation figures, central banks throwing their zero interest rate policy overboard, and of course continued Corona restrictions, especially in China, affecting global value chains, as well as geopolitical tensions everywhere. This should actually be enough for a veritable crisis, and this was then also the case: However, not so much on the stock market, where one could get used to distortions in the last two decades, but on the bond markets, where one could otherwise always feel comfortable even in the darkest hours and where the central banks helped out in case of need. On the German bond market, the gains of almost the last ten years have gone up in smoke within a few months. As a result, attractive interest rates are now by no means being offered, as should actually be the case after price collapses: Interest rates continue to be more or less significantly below current and expected inflation rates. Real losses are therefore almost guaranteed for the next few years.

What counts now for looking ahead?

In an extremely difficult situation, Germany and Europe have so far come out of the woodwork far better than feared. The consistent stance against Russia and the support for Ukraine as well as the cohesion in NATO with the USA are a remarkable political development that could not necessarily have been expected a year ago. The associated cessation of Russian gas supplies was largely compensated for in the short term, with the state stepping in to compensate for short-term hardship. A looming nightmare turned into an opportunity to dynamize the energy transition, perhaps to reduce the rampant bureaucracy and focus on the essentials, which was perhaps grasped even more quickly in the private sector than by many in politics and administration.

Many companies well prepared

The looming recession feared by all sides has been anticipated for at least six months, measures taken, inventories reduced, fewer risks taken. This should noticeably slow down the recession, if it does come: A recession is always most unpleasant when no one saw it coming and no preparations were made. On the negative side, many companies are still benefiting from the order backlogs

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accumulated during the corona pandemic, which are now gradually running out. Rising interest rates will also take their toll on debtors, often only gradually as low-interest loans expire. On the other hand, creditors are the winners of this development (in nominal terms, not in real terms, see above) on the one hand, and the fact that interest rates are still not high in the longer term on the other: Companies that are already having problems under the current circumstances should perhaps fundamentally rethink their business model.

Inflation and the role of China

Two key positive aspects from an equity market perspective are the inflation outlook and the lifting of corona measures in China. Inflation dynamics are pointing steeply downward, and last year's price bubbles have largely disappeared. Gas in Europe costs about the same as before the Ukraine war, oil prices, transportation and logistics costs, used car prices are all in reverse. As the chaotic lockdowns in China come to an end, supply chains will continue to normalize and shortages will be eliminated or reduced. This should put downward pressure on interest rate expectations, which in turn will be good for stocks. In China, growth is likely to accelerate again, which will also support global growth.

Crises and their impact on prices and valuation

Like everyone else, we don't know how the next few quarters will play out. What we do know is that, despite the recent recovery in prices, a great many stocks are still valued quite low under reasonably normal circumstances. Thus, the recession, should it come, should already be reflected to a large extent in prices, but a recovery should not. As already mentioned, this is supported by the fact that German and European equities have performed reasonably well despite the extremely difficult conditions and have outperformed U.S. equities for the first time in more than a decade. No comparison with the losses of, for example, the dot.com crisis 20 years ago, which was actually a non-event from an economic point of view, or the banking and European sovereign debt crises, which could be solved by simply "printing money". Today, as in the Corona crisis, the actual and feared problems are and were more existential. And this has also been reflected in the valuation: The price DAX, i.e. the DAX, which is calculated in a comparable way to the S&P index, namely without the dividend payments, has just exceeded the high of 2000. German national income has almost doubled since then, and the fact that German companies are now much more international than they were then and have been able to benefit from higher global growth is also not reflected in the share price performance.

Dividends are at record levels, as are dividend yields, and here companies tend to be reluctant to cut back unless they absolutely have to. Many stocks, even with very solid business models, are trading at a discount to book value, something that used to be reserved for companies that were losing money. The fact that inflation is expected to be higher than in the last ten years is also in favor of equities: companies are the ones that can raise prices. In this respect, nominal growth is achievable for more companies than was the case in the last ten years, which in turn argues in favor of "value stocks". The scarcity premiums for stocks that can achieve growth in an environment with very low inflation should thus fall, which makes these stocks look less attractive in view of the still high valuation premium after, as already mentioned, the winners of low interest rates such as real estate or growth companies have already incurred noticeable losses. So to speak, stable growth stocks are "the last shoe to drop".

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Germany's competitiveness and the banished risk of insufficient energy supply

The greatest threat to German companies in recent years has been the risk of insufficient energy supply. This problem has been solved for the next two to three years anyway and, in all likelihood, for this winter and next winter as well. The perception of Europe and of Germany, especially by the rest of the world, is far too negative from our point of view, even though this does not mean that all problems should be talked down. Germany's success and prosperity are by no means - contrary to what is often said - essentially dependent on cheap energy imports. And that of globally active companies is certainly not the case. Energy is very cheap in the developed economies, especially in the USA, where specific consumption is correspondingly higher because energy savings bring lower benefits. Now we can ask ourselves which of the American megacaps owe their success to cheap energy. Energy is processed and consumed locally, either directly or in many products. The number of end products that are transported around the world with a high value energy content is very moderate. In this respect, all of this only affects Germany's external competitiveness to a limited extent.

Positive outlook – despite it all

Who it will affect: It's the consumers. That's annoying, but we're talking about an order of magnitude increase in the cost of energy imports, which should ultimately amount to perhaps 40 to 60 billion euros for Germany. That's 1-1.5% of national income, or roughly the annual increase in productivity. I will bet that a consistent reduction of senseless bureaucracy should bring many times that amount in savings. Now that the whole country seems to be rejoicing that liquid gas terminals can be built in ten months instead of ten years, that would be a good time to consider the latter. But again, none of these are good reasons to buy or sell stocks. The only reason that makes sense in the long term to make an investment is the attractive valuation of a stock. And here, after a year of chaos and confusion, there is plenty of choice to be had across all industries and sizes of companies. And so, despite all the recession fears, we expect 2023 to be a much better year.

Sincerely yours,

M. Wirth

Martin Wirth

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