FPM-Comment Reducing the Noise

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No place to hide on the financial markets – and how things could continue with a clear head and a rational approach

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- Massive bulwark against share prices falling further
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If we thought several times since the turn of the millennium that something bad had now happened that could not be topped, we have again been proven wrong in 2022. The recession of 2001 (noticeable only by falling share prices, which had previously been overpriced), the financial crisis of 2007 to 2009, the debt crisis of 2011, the distortions in international trade triggered by Donald Trump, all followed by the Covid-19 pandemic. From today's economic perspective, this caused massive damage through the lockdowns, but also through the various government interventions, which are only gradually coming to light. Keywords are the chaos in production, logistics and administration as well as a shortage of personnel in many regions, for example due to government cash gifts, especially in the USA, which ultimately caused an inflation not seen for decades. The latter, of course, was also caused by panicked central banks with extremely expansive monetary policies. And now a war in Europe, which Russia has instigated against Ukraine. Apart from anything else, this has also contributed to inflation and shortages of important goods to a considerable extent. For the time being, only the use of atomic bombs, a war between China and the many states regarded by China as rivals, and a comet impact remain as possible increments. As well as of course the climate catastrophe with its consequences.

Massive bulwark against further falling prices

As you can see, we've already come a long way, but there's worse to come. In any case, the market is not being driven by pleasing underlying conditions or excessive optimism. And negative surprises are something that no one wants to rule out anymore and will take into account in some form in their investments. After all, all of this forms a formidable bulwark against further falling prices: if you don't look at the indices and their reasonably solid performance due to a manageable number of

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large-cap stocks, you will see a large majority of stocks that are miles away from their highs of the last ten years.

Inflation, interest rates and the war in Ukraine are massive headwinds

Since the beginning of the year, the headwinds for the markets have been at record high levels. One was the underestimated inflation as well as the equally underestimated aggressive willingness of central banks to fight inflation, but most of all the rising long-term interest rates, which only a minority of investors could have imagined rising ten months ago. The same applies to the war in Ukraine: first, that it is taking place at all. And then, that Russia, having failed to achieve its goals, chooses the path of escalation at every point where there are several alternatives.

But: under the circumstances, relevant aspects have developed better than expected

Many things developed better than expected: Ukraine's defense readiness and capability, its support from the West, but also the significant weakness of Russia. Strategically, this could represent a huge gain for mankind, even if it will entail considerable costs in the next few quarters and in purely economic terms, particularly in Europe and especially in Germany, as can be seen from the development of share prices. The good thing is: Russia, as the global schoolyard bully and role model for many other autocrats, has shown itself to be much weaker than expected by all who have had to put up with and accept its posturing for decades. The price of an improved world order is high, especially for Ukraine, of course. But it was due at some point, as we now know, and: it is probably not nearly as high as feared. Another positive aspect is the West's ability to free itself from Russian energy supplies for the foreseeable future at high cost, but without the collapse of industry and society. Germany seems to be prepared for the winter under normal circumstances, and companies have also taken a variety of measures. BASF can serve as an example: Whereas in the spring it was still said that the Ludwigshafen plant would have to be closed if capacity utilization fell below 50%, it is now said that solid profitability already begins at 50%. This may be at the level of the contribution margin and by focusing on higher-value products, but it is a far cry from the doomsday scenarios in the spring.

No place to hide on the financial markets

In 2022, there was hardly any place where you could safely hide your wealth. Government and corporate bonds, highly valued growth stocks, low-valued normal stocks: all of these were under pressure, and due to the special situation, especially in Germany. Valuations are a key driver of share price performance in the longer term and, unlike other drivers, are easier to assess. In the short term, however, deviations from expectations dominate. And this is where companies deteriorated throughout the year, so that there was a permanent reason to sell shares. With few exceptions (energy, agriculture, partly banks), companies were affected by deteriorating business prospects (rather the "value" stocks) or became victims of their high valuation, which suffered from rising interest rates. Combined portfolios with an equity/bond mix posted the worst results in the U.S. in the last 100 years, except for 1931 and 1937, which helps to put the proportions into perspective.

Cash was also not an option from the start: real losses in Germany equal to the inflation rate were inevitable, which in hindsight was still far better than what happened to owners of stocks and

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bonds. So all in all, it was a disaster that investors could hardly defend themselves against.

The question now is what happens next and how to assess the situation.

Buying in a recession has proven to be the best strategy

First of all, it's not during a recession that markets do poorly, but on the way there. During a recession, stocks tend to perform poorly when they were previously highly valued and well when they were not. After a recession, performance is dramatically positive. The trouble is, you don't know a recession has officially ended until months after it's over. To that extent, you have to bite the bullet and buy when the situation is uncertain but stocks are cheap. As already announced in the last quarterly report in July, a recession this winter is as good as a foregone conclusion. That is also the consensus now. To that extent, there is widespread clarity in this regard. The open questions are: How long will the recession last, and how will interest rates and inflation develop? Without having a pronounced opinion on this, it is obvious that the markets are now expecting aggressive action by the central banks, which is therefore also likely to be priced in. As it looks, the cycle of interest rate hikes may already be over by the end of the year. It should also be noted that rising prices, especially in Europe and Germany, will have a significant restrictive impact, which will complement the effect of the rate hikes. In that respect, this doesn't just look like a full stop, it is one.

What is crucial for the further development is how inflation rates develop in this environment, and there is not only bad news here. Various commodity prices have been falling for months, reflecting weaker demand. The enormously high inflation rates, which are currently even more prevalent in Europe than in North America, are mainly due to the distortions on the procurement side. This will probably return to normal to a large extent in the coming quarters and years. This is not possible in the very short term, and no restrictive central bank will help. How strong second-round effects will be remains to be seen. Initial wage settlements in Germany look reasonable in view of the parameters.

Even though the upcoming recession, especially in Germany, could be more severe than is usually the case, it has the advantage that it has been expected for months and will therefore not be a surprise to be prepared for. Anyone who hasn't factored that in now is probably in the wrong place.

What is more difficult than in previous recessions is the lack of clarity about the availability of, for example, various preliminary and intermediate products. Not everything looks solved, but the situation seems far better than was feared a few months ago under the current conditions. The quantities are one thing, the other is the prices, which seems to be of only marginal interest to green politicians in particular, as became apparent in the nuclear energy debate. To put the dimensions into perspective:.

Gas prices are important, but not alone decisive for the German economic model

The increased gas prices have the effect of a massive tax increase, unfortunately by foreign countries, and this time also as a tax per capita rather than geared to individual performance, which primarily affects private consumers. In the corporate sector, the dislocation varies depending on whether companies need a large or small amount of gas, have hedged their procurement costs or not, need gas for higher- or lower-value products, suppliers can continue to produce, or production can be moved to countries where much

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lower gas prices must be paid. According to estimates by the Ministry of Economy, the costs are €60 billion in 2022 and €100 billion in 2023, equivalent to just under 2 - 3% of Germany's national income. By way of comparison, the EEG surcharge to finance green electricity has been between €10 and €16 billion p.a. since 2010, while the gas bill has been around €20 to €30 billion in recent years. How high the actual burden will be remains to be seen. When the new sources of supply have settled down, the annual additional burden is likely to be around €30 - 40 billion, i.e. 1% of national income. This is really not the end of the world and usually corresponds to the productivity growth of a single year. To attribute the success of German companies to low energy prices is ridiculous. Perhaps the state will also manage to reduce the excessive bureaucracy. This could be made easier by the fact that it is visibly suffering from it itself. Then a positive result could still emerge from this and overcompensate for the higher gas bill.

The government will shoulder most of the additional burden and stretch it out over time

Two factors are uncertain:

One is the question of who will pay for all this and when the bill will come due. With the "double whammy" of up to €200 billion, or 5% of national income, the government has decided firstly to socialize a large part of the additional burden and secondly to stretch it out over time. This means that, correctly calculated, new German debt will be roughly on a par with the usual French level, outside times of crisis, mind you. In this respect, there is no reason to get upset if one follows the usual European line of reasoning. This will considerably mitigate the expected recession, even if the distribution effect is not certain because the measures have not yet been fixed. However, the basic principle should be obvious to everyone, even if the clamor is still great due to the lack of specification. With the rising national debt thanks to the once again adopted extraordinary budget, the demand shortfall will be at least partially offset, and in purely arithmetical terms even to a large extent. The bill that is paid to Norway and other states is thus paid by the German state. For the recipient states, on the other hand, the bill looks the other way round, of course, minus the additional logistics costs compared with the earlier Russian delivery. In sum, the recession could thus be less severe than has recently been feared in some quarters.

What is also uncertain, but relevant, are the indirect effects of skyrocketing gas prices. On the one hand, there is a shortage of products that are gas-based but have low value added, from carbon dioxide for the beverage industry to fertilizers. In addition, and probably more important, are the distributional effects of distorted prices. Known and discussed everywhere are the windfall profits of power producers who benefit from the high electricity prices driven by gas. Depending on how these are handled, they will also be in the tens of billions of dollars. Regardless of where you stand on this, it leads to further increased uncertainty. On the other hand, much of this money will remain in the domestic market. This problem is also temporary. However, it will not be solved by building a lot of renewable energies, which in boundless naiveté is supposed to be the solution, but by procuring the raw materials for the controllable energies from other sources. But here we can be sure that this will happen. Even if it is not always the most tepid who understand the most, if you follow the debate about the merit order principle.

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In relation to nominal national income, the additional debt is less significant

A few more figures to classify the costs of the "double whammy" and the distributional effect that the current environment has. Anyone who is now frightened by the sum of up to €200 billion should bear in mind that it is probably not the general public that will bear this damage. Assuming that Germany grows little in real terms in 2022 but will have inflation of an estimated 8%, this will lead to an increase in nominal national income of almost €300 billion. Thus, this alone will hardly increase the debt ratio, especially if a good part of the government support falls into 2023. If we then take into account the fact that government revenues will benefit significantly from inflation, it is not impossible that the government could mathematically be on the winning side despite rising spending.

Economically, the bill will ultimately be paid by nominal savers

So who pays the whole thing? The nominal saver. And in a breathtaking order of magnitude: If the real (gross) redistribution in the last years with negative interest rates and a manageable inflation was approx. 50 - 100 billion € p.a., it is 2022 rather 400 (!) billion €. Who may not believe this: Here comes the calculation. German financial assets, largely fixed-interest, amount to more than €5 trillion, and with interest rates of 0% and inflation of 8%, this results in the above-mentioned loss of real value. And this does not even include the price losses of bonds! Whoever believes that nominal interest rates of now 2% for ten-year bonds are attractive should think about it again and not completely ignore the expected inflation rates. Or he doesn't care what investors get in real terms. At least, one can see here at first glance what is commonly understood by "financial repression": The sometimes slower, sometimes faster expropriation of savers by government action, starting with interest rate manipulation by central banks. In recent years, this has given states the opportunity to largely avoid unpleasant reforms, but instead to heartily expand bureaucracy and the welfare state. The appreciation for the latter has been limited, as can be seen in the media on a daily basis. And there may always be more: In Hesse, the number of teachers has risen by 50% in the last 50 years, while the number of schoolchildren has fallen by 25%. Even here possibly not apples with apples compared: One might conclude that this is a substantial improvement. Instead, there are complaints of a massive teacher shortage and warnings of the collapse of the school system. By contrast, no one has audibly warned of an expropriation of savers. This is hereby done for the readers of this report.

Last but not least, another possibility should not go unmentioned: Inflation will collapse and fall back to a level below 2%. And even that is not completely out of the question, although probably not next year, as second- and third-round effects will still be driving prices then. And then the central bank will simply continue repression at lower levels.

Shares are real assets whose prices are temporarily depressed by the underlying conditions

This is also where it gets exciting for stocks. At the moment, the market is busy guessing and pricing in the difficulties of the next few months. This is nothing new: looking at the situation six months from now is the core competence of the stock market, seriously and without blinking an eye. It is obvious that the earnings estimates currently circulating are too high. Analysts are guided by the

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forecasts of companies, and these in turn have to comply with various formalities in order to adjust their official expectations, to put it simply, and this takes time. One could now say why it is not possible to anticipate this. Answer: The stock market takes care of that all by itself; the analysts' estimates merely follow reality here. That's no big deal, because analysts have much more relevant functions than publishing the ever-correct earnings estimate.

As economic expectations fell, so did share prices

As economic expectations fell and interest rates rose, stock prices fell. Unsurprising as far as that goes. On the other hand, however, the vast majority of companies have managed to pass on a large part of the cost increases to their customers. In a recession, this may be temporarily different. Nevertheless, when the general conditions stabilize, equities, as opposed to nominal investments, will have been able to compensate for inflation much better than bonds or savings deposits, which, as I said, is already becoming apparent today. So how is it that stocks are falling? Precisely because of the focus on the next six months, the short-term news situation and, perhaps strongest of all effects, the liquidity needs of many market participants. Thus, one has the chance to use one's much more devalued liquidity to buy stocks whose value, in most cases, may have fallen little in real terms and certainly not at all in nominal terms in the long run, but which have nevertheless become much cheaper. Looks like a good deal.

... and are trading today in many cases at record low valuations

German stocks today are in many cases trading at the lowest valuation levels of the last decades, measured by substance rather than volatile earnings. In this respect, the opportunity for a solvent and medium-term oriented investor is clear. What is unfortunately completely unclear is: How solvent are other market participants? If you have to liquidate, you sell, regardless of the valuation. What has happened in the bond market in recent months is of epochal proportions. The realization that most of the gains in the bond market over the last ten years were borrowed only in the form of temporary price gains and are now vanishing into thin air is difficult to assess in terms of its significance for the solvency of many investors. With many investors unable to withstand the volatility of equities for regulatory or other reasons, a valuation premium in favor of equities has built up to record levels over the past 10 to 15 years. This does not even take into account the fact that equity valuations reflect real interest rates, while bonds offer only nominal interest rates. Which, in real terms, simply vanishes into thin air.

Stocks as real assets usually suffer less than average from inflation ...

This does not mean that everything is fine on the equity side. Looking at the current performance, one can see what is deterring potential investors in the stock market. However, in the current environment, all sorts of things are being thrown into disarray. To show the potential that exists even in an inflationary environment, let's look at real estate stocks, a category we have avoided in recent years because of artificially depressed interest rates. Here, the market sees three problems at the moment: Rising interest rates are reducing the present value of future earnings, while at the same time making it more expensive to finance debt. This means, c.p., that the earnings value of companies has fallen. This can be seen in share price losses of 50 to 80%. In addition, there is the question of how well the tenants can bear the increased operating costs. What the market completely ignores is the fact that the net asset

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value has risen: building apartments has become more expensive, so the existing properties are not being displaced by cheaper new buildings. At the same time, rising wages are also increasing the nominal financial strength of tenants, which means that rents will also rise over time. In addition, bond prices have fallen significantly, which means that shareholders who would buy at today's prices have gained further value from the low-interest financing.

... and should at least compensate for the discounts when the overall environment returns to normal

As you can see, it is anything but clear what the effects of inflation and rising interest rates are in the case of real assets, and these are represented by equities. We would like to refer once again to the nominal pension obligations, some of which have collapsed, and which have often enough been valued in the perception of many market participants as if they were immediately maturing financial liabilities. On balance, we believe that the shares of many companies should have held their REAL value despite the current turmoil, even if the next six to twelve months may not be particularly pleasant. Even temporary declines in earnings have little impact on sustainable value. High inflation rates will be, or already have been, passed on to customers over time; otherwise we would not have inflation. The exceptions will be those stocks that were previously trading at inflated valuations. The owners of nominal values will pay for this - and complain later that certain people are getting richer and others are stuck.

Summarizing the overall situation, we see the following picture:

- Interest rates and inflation rates have risen significantly and, with a view to falling commodity prices, will probably soon be close to their highs.

- Central banks, faced with the social implications of higher inflation rates, have reversed their direction almost in a panic and will raise interest rates very quickly, perhaps even overshooting them given the causes of inflation.

- Thanks to falling prices, valuations of many stocks are hovering at decade lows. Sentiment is poor, investor positioning is very defensive, and hedges are very high.

- In the coming months, the news will not be good. However, further price declines would require undercutting current fears. Adjustments of earnings expectations do not fall into this category: Nobody really takes today's earnings estimates seriously.

- With a not exaggerated investment horizon of one year, one should imagine what the situation may realistically look like in one year's time. Assuming the worst case is not constructive.

- However, one should keep an eye on the distortions in the bond markets, which are dominant in terms of magnitude, such as the pressure on the liquidity of relevant players, and as an investor always remain the master of one's decisions.

The war in Ukraine will drag on, but will not be relevant in the medium term as long as Russia does not ultimately escalate. The gas shortage will gradually clear up over the next few years, and the path is increasingly clear today. Again, the bigger problem may be the interest rate markets. Here, many market participants have lived for the last ten or more years on the illusion that their profits were being earned on an ongoing basis, while an increasingly large part of the return was attributable to price gains thanks to central bank purchases. Now, in just a few months, the profits of five to ten years have vanished into thin air,

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in contrast to companies whose real substance has risen constantly. In this respect, the question of solvency arises for many market participants, exacerbated only by derivatives that were supposed to be used to manage earnings and are suddenly no longer liquid.

Very briefly, the very large opportunities at present are matched by very large uncertainties, and vice versa. Otherwise, valuations would not be where they are. The best advice we can give is to keep a cool head and take a rational approach, to see opportunities and not just risks, and at the same time to bear in mind that not all market participants can do the same.

Sincerely yours,

Martin Wirth

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