FPM-Comment Reducing the Noise

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A recession is not the end of the world, but the usual course of events

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- The limits of macroeconomic analysis in investing
- Recessions generally provide good buying opportunities for equities
- Varying degrees of resilience to rising interest rates
- Indications of favorable equity market valuations and a return to business as usual
- Our kind of optimism or: Don't focus too much on the political environment when investing

The recession that has been smoldering in Germany for the past year, which began in the manufacturing sector, has now become apparent, but without having increased in severity. In the EU, the situation is not much better. In the USA and other regions of the world, the economy is also not particularly solid, but neither is it in recession.

The reasons for this are the slowdown in government transfers following the pandemic and the significant rise in interest rates, which are being used to combat the higher inflation rates caused by the previous increase in transfers and the war in Ukraine. For some economists who follow Modern Monetary Theory, it was surprising that printing money and increasing government debt do not create wealth. In the left-wing political camp (beyond the SPD center, just to clarify) obviously likewise, where printing and distributing money is known to be a core competence. In Germany, it was added that further economic procedures were to be abrogated in a hasty procedure, and the result can now be marveled at (or not, because it is not surprising).

The limits of macroeconomic analysis in investing

Just to make it clear: Economic aspects are not the core of our investment process. We simply use them to evaluate the environment and try to identify divergences between facts and opinions, just as we do at the equity level. Opinions or the perception of facts naturally influence sentiment and the willingness to invest, and thus explain a large part of the valuation fluctuations in the overall market. But each company has its own investment case, which often has nothing at all to do with the macroeconomic environment, but whose valuation is influenced by it. In this respect, an understanding of the general conditions is absolutely essential in order to be able to assess an investment and its valuation appropriately. One example is real estate stocks, which were driven by zero interest rates and have taken a disastrous turn with the normalization of the interest rate landscape. Although not quite as bad as the long-term bonds, after all, one is also invested here in real assets which, on the one hand, have always been able to generate rental income and whose nominal values have undoubtedly risen over time, unlike those of the bonds.

In addition, the assessments of the environment help to build a portfolio that takes into account uncorrelated or negatively correlated risks, which is particularly appealing if the resulting diversification can be obtained at a low price. Of course, it does no good (at least much less good) if you buy it too expensively. As examples: Banks benefit from rising interest rates, but most stocks do not. The same is true for commodity-related companies with respect to inflation, or defense companies to offset global crises. This diversification is not the main reason for an investment but can make a significant difference in the investment decision, all other things being equal.

What you also have to take into account when it comes to economic conclusions: Economists talk about the economy, but they have little idea what this means for stocks, since it is not their job to deal with this. It is therefore very dangerous to rely primarily on macroeconomic statements when making an investment decision. Otherwise, you run the risk of regularly exiting the markets at the bottom and re-entering them at the top. Recessions are times when it has historically been better to invest. If you want to get out of stocks, it is better to use boom phases to do so. Because a recession is not the end of the world, but simply the normal course of events. The mistake you can make is to ignore this normality. In addition, it should be taken into account that statements on the valuation of shares from a macroeconomic perspective regularly only apply to the level of the index, i.e. valuation differences between the individual market segments, let alone individual companies that are not taken into account at all, or are treated with the remark that the market is always right. Of course, this is nothing other than refusing to do the job. Because if the market is always right, why does it change its mind every day? If you then combine half-baked statements with so-called artificial intelligence, which regularly exhausts itself in trend-following models based on the latest revisions of results, then a lot becomes explainable. Where investors take a closer look, however, because decisions are more difficult to revise, is in private transactions, for example in the area of private equity investments. And here, valuations now deviate significantly upwards from what is being called on the stock markets. But all this is just a side note. Last remark: In almost 35 years in the industry, I have never seen an economist who was really optimistic. They have that in common with the bond market. Skepticism sounds smarter, but it doesn't make money.

So back to the topic: The economies have been deprived of monetary steroids, but things don't look so tight yet in terms of fiscal policy. Since

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Germany is once again a bit more prudent than most other countries, this is an additional burden on the national economy.

Recessions generally provide good buying opportunities for equities

All in all, this is not an easy situation, but it is also far from a disaster. This also explains the high stability of the stock markets that appears at first glance, but again, only at first glance. Beneath the surface, there have been some significant shifts. In particular, a number of highly capitalized stocks recorded a solid performance on the basis of a valuation that was previously at most reasonable and in some cases low, and a business that was by and large stable. The same applies to a whole range of mid- and small-cap stocks. Those who suffered significant price losses in some cases were not only cyclical stocks, as you might expect, but also, and in some cases to a much greater extent, companies previously traded with high growth expectations. The victims of rising interest rates lost, the profiteers gained, unsurprisingly. And all in all, as has been the case for years, the market moved sideways in a stable range, or, including dividends, slightly upward.

Varying degrees of resilience to rising interest rates

This is not self-evident insofar as interest rates have risen significantly worldwide for almost two years. Since their peak, the prices of U.S. government bonds with 10-year maturities have lost almost 50%!!! (in words: fifty percent). Investors in German Bunds have earned nothing in nominal terms for more than 10 years, not to mention real losses. Interest rates are the anchor on which all valuations are based. A few years ago, it was a horror fantasy that central banks would raise interest rates even in the 1-2% range. And now: not much is happening at all, across the board, and in aggregate, not even in equities. Which in our eyes is crystal clear evidence of the low valuation of equities, which in turn is evidence that this tectonic shift in interest rates had already been partially expected in equity prices. And shareholders, unlike bond investors, have not been fooled by central banks, especially that wealth could be created by printing money. This distinguishes them from bond investors, who are supposedly much smarter than the more simply structured stock investors.

Resilience to rising interest rates, however, does not apply to all sectors of the economy. There are, and will continue to be in the near future, enough headlines about companies and structures that have been swept off-course by rising interest rates, i.e., that are getting into substantial trouble because of the devaluation of their previously inflated assets or because their cash flows are insufficient to service their debts. First and foremost, of course, is real estate, but also investments in such things as renewable energy production parks, whose attractiveness was partly fed by the fact that the debt capital needed for the investment could be had almost interest-free. And further, there are no limits to the imagination here. However, one should not be deterred from not entering into attractive investments: For everyone who has to pay higher interest, there is someone who receives higher

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interest, to that extent this is primarily a redistribution issue, and geniuses who were just celebrated now look quite out of place. As Mr. Buffett once said, "Only when the tide goes out do you discover who's been swimming naked." But most of them are swimming in their trunks (and swimsuits, to be gender correct): For the vast majority of those who are solidly financed, the calculation is that higher interest rates will be compensated for by higher inflation rates. As a result, there are likely to be jolts here and there, and the result is the slight recession described above, which has been ongoing for more than a year. And there is no clear improvement in sight for the time being: The effects of higher interest rates will become apparent gradually over a longer period of time. If you adjust to this, the surprise will be less unpleasant. However, one thing should also be noted: If a normal company gives up an investment because interest rates have risen from perhaps 1% to 4% or 5%, then the investment was not a terrific one to begin with, and the business model was not exactly convincing.

Doubtful motives for bond buyers

Despite the poor performance of recent years, the outlook for bonds is likely to remain modest going forward, except for some interim relief. There will continue to be no, or at most low, real returns. This is quite different from equities, even if this will not always be immediately reflected in share prices: Companies whose business model is only rudimentarily any good will pass on their cost increases to customers, at least in part. Ultimately, this is where inflation comes from. Even if it is clear that labor will become relatively more expensive in the Western countries due to demographic factors: The losers are not primarily the companies, but the savers in nominal investments.

In practice, of course, there are still reasons to buy bonds instead of shares. Two groups of buyers have to be distinguished:

- Some don't know what they are doing, because 3% interest with 3% inflation is a guaranteed capital loss after taxes, or:

- If, for example, regulatory requirements demand a return of 3%, then you can just buy bonds and have done your job and can go home early. Whether the customers consequently lose money is irrelevant, because from the formal perspective, everything is fine.

Or there is a future in which inflation rates fall back to zero (where, properly calculated, they never were), which would be quite astonishing, to say the least, in view of the financial policies visible around the world. In a world where the media hype people like Bankman Fried, the former crypto billionaire and current defendant (to name just one case, Markus Braun of wirecard should not be left out either), one should not be under too many illusions about the precision of the analysis of many participants in the financial markets. At the end of the day, we should thank those who so generously support the economy with their savings, which ultimately also benefits the shareholders.

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Indications of favorable equity market valuations

So back to equities. How can it be proven that valuations are currently low? For one thing, the formal metrics, such as P/E ratios or dividend yields. Both earnings and dividends can change quickly. A more sustainable metric is the price-to-book ratio or, in absolute terms, enterprise value. Here we are seeing record lows in series, the kind of lows that are only reached during recessions. Which is understandable, since we are in one. And buying in recessions has rarely been a mistake in the past. It should also be noted that the dispersion in valuations remains very large, and the figures aggregated at the index level look nowhere near as spectacular as already indicated. If the usual patterns hold going forward and the end of the world is not imminent, then there may be substantial opportunities here. Those who do not trust all these figures may find reassurance in two other aspects. Firstly, German companies are buying back shares on a scale that was not even remotely expected a few years ago, provided they are not trying to protect their cash flows. This includes many companies in which families are major shareholders, who are therefore (hopefully) not primarily thinking about share price maintenance or compensation for distributed stock options. Furthermore, it is striking that insiders have been almost exclusively on the buying side of the reported transactions for months. There are different reasons why people sell a stock, but really only one reason why they buy. And that is with one's own money.

Why this might be a good idea can be illustrated using various examples which show that we are already well advanced in terms of economic weakness and that the drop-off should now be comparatively low. For example, global auto production is more than 10% below its peak in 2016/2017, which has not prevented German manufacturers from achieving record results. Chemical production, which is generally quite stable, is 20% below the average of the last 15 years in Germany, which is probably more towards the lower end of expectations despite the very high energy prices and is primarily due to destocking rather than high costs. This extends from logistics to retail, where the current business situation after the pandemic boom is pretty lukewarm. By contrast, the service industry looks quite encouraging, so the record results achieved here in some cases are probably not sustainable. However, no one seems to believe this when looking at the current valuations. Conversely, the same does not seem to apply to the depressed results of the manufacturing companies.

Return to business as usual

The recent much more pronounced fluctuations in the economy are due to the two major events of recent years, the pandemic and the war in Ukraine. Initially, money could only be spent on goods and no longer on services; the states distributed money that had not been earned and was now encountering reduced supply, combined with shortages in the logistics chain, which in turn led to precautionary excessive stockpiling, accompanied by the low interest rates of the central banks, all of which in sum led to significant price increases. Now, for the past year, the movement has been in the other

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direction, including exaggerations: Windfall profits are disappearing, wages are rising and putting pressure on margins, logistics are functioning more normally again, so there is also less need for increased inventories, and instead these are being reduced, ultimately also driven by the increased interest rates, because all of a sudden inventory financing is also costing money again.

These deviations from equilibrium will level off again, as these fluctuations are far from reflecting largely stable final demand. At the same time, companies are taking advantage of the current weakness in demand to improve their cost situation. It should also be borne in mind that falling prices for industrial products are squeezing margins, insofar as more expensive purchased products are gradually processed while the end products have already arrived at a reduced price level. However, the oil price, which is rising again, indicates that there is already a countermovement at this level and that the pressure on margins will disappear in the foreseeable future or even turn into the opposite. The same applies to the reduction of inventories, which will obviously be completed in the next few months. So everything is actually business as usual, if one disregards the size and sharpness as well as the shortness of the amplitude.

Our kind of optimism or: Don't focus too much on the political environment when investing

Anyone still waiting for a drama has spent the last few years in a deep sleep. Pandemic, war in Europe, energy crisis and, most recently, an explosion in interest rates: the global economy has come through all this with difficulty, but by and large successfully. It is likely that future growth rates will be lower than in the past. The only thing is: growth is practically not priced into current prices, nominal stagnation at best is expected for most sectors, long-term moribundity for many industries, and ultimately the disappearance of most companies. It is also the case that European policy-makers, and German policy-makers in particular, have an extremely poor understanding of economic interrelationships. Not to mention the psychological component, which, according to Ludwig Erhard, accounts for 50% of the economy, but then he was a professional. However, in the end, economic realities regularly dominate the ideologically driven wishes of politicians, ranging from Agenda 2010 to the continued operation of coal-fired power plants that are not completely climate-neutral, and once this is not the case, in many cases there is the possibility of avoiding the whole thing and, for example, gradually relocating one's production. Either way, however, we are talking here about a small part of the entire national economy that is structurally at risk, and should something actually be sustainably economically destroyed at some point: This is almost always already priced into the shares several times over.

We therefore continue to see the opportunities as significantly greater than the risks, provided that the overvalued part of the stock market is avoided. Many valuations are at long-term record lows, so the difficult conditions are probably reflected here in excess. And to all those who disagree with current politics in Germany (two-thirds of the population according

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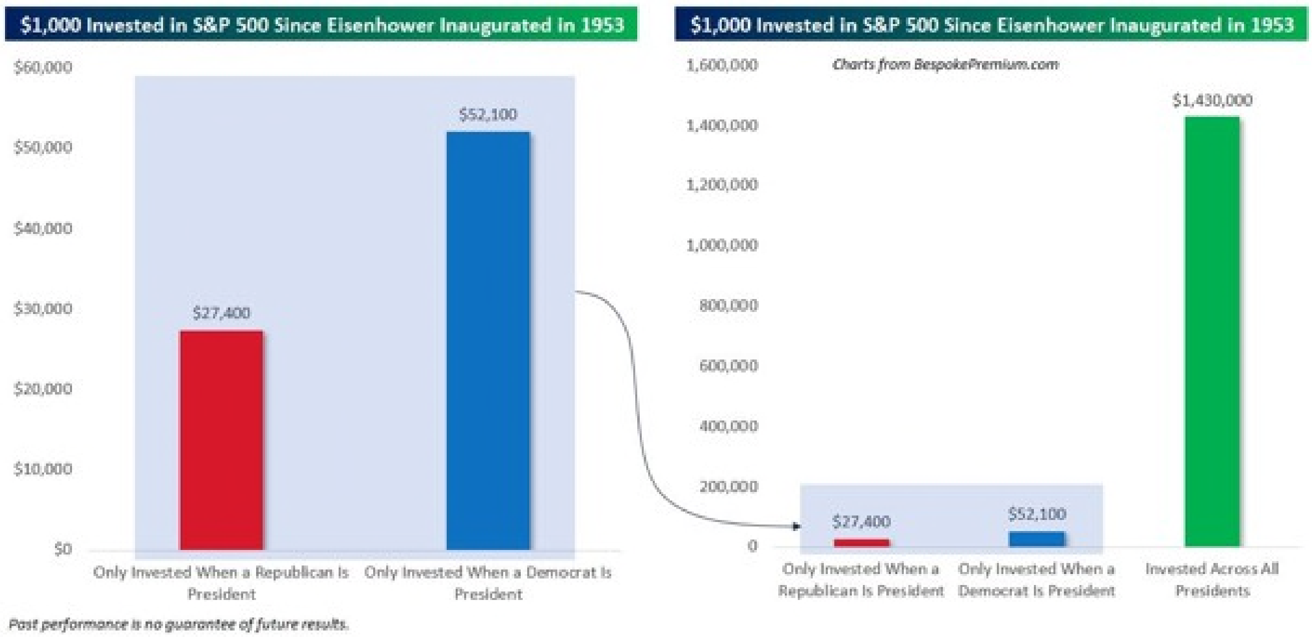
to surveys, and perhaps some readers as well): One should never make the mistake of basing his investment decision on his political attitude as long as the society system is the same. Illustrated by the chart below.

Simply staggering. Even if the interest rates of the alternative investments are not taken into account here.

Sincerely yours,

Martin Wirth

Don't let your politics get in the way of buy and hold!



Quelle: Bespoke Investment Group

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