FPM-Comment Reducing the Noise

Martin Wirth – 1/2019 dated January 22nd 2019

2018: risk minimisation was top of the agenda ... and 2019: the final chapter in the correction

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- 2018: shares dropped in unison and risk premiums hit new highs
- Present situation does not point to another crisis
- Reasons for what happened in 2018
- 2019: the correction is now well advanced in our view
- Overall market: correction has generated considerable opportunities

Risk minimisation as top priority

2018 was a very unsatisfactory year on the international equity markets and especially on the German market. It was therefore a mirror image of the excellent performance in 2017. While the FPM funds derived above-average benefit from the positive trend in 2017, the subsequent losses were also disproportionately high. At the end of 2017, we believed that both the market and the real economy were returning to a more normal level of risk aversion, but 2018 developed into a year in which risk minimisation took priority over everything else. There were several reasons for that.

As of today, and without wanting to pre-empt the outlook, there are signs that growth rates are normalising, presently to a level that could be below growth potential, whereas in 2017 and the first half of 2018 growth was still above the sustainable level. In the absence of a serious recession, the drop of 30 % or even considerably more in the share prices of many companies would only be justified if they had previously been significantly overvalued. In absolute terms, that was the case for a few companies, but it certainly did not apply to the broad majority, even though earnings power in recent quarters could not always be regarded as sustainable. Moreover, shares in companies fell more or less in parallel, irrespective of their valuation. In our view, this was based solely on which sector they belonged to, despite enormous differences in earnings performance.

That was not entirely due to the economic situation, as evidenced by the fact that even noncyclical companies saw their share price

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nosedive if they failed to meet expectations for whatever reason.

Companies that held up well were those whose prospects were considered to be stable and/or whose profits did not fall short of expectations or surprised on the upside, as long as they were not in a cyclical sector. That had nothing to do with valuation. Consequently, expensive shares in companies of above-average quality became even more expensive. The risks of investing in such companies became clear from those companies that were previously considered high-quality but which then disappointed (even if only temporarily). In such cases, there was a massive drop in the share price a result of the previously high valuation (as quality stocks where nothing could go wrong).

As long as the global economy does not slide into a serious recession, present valuations are below the sustainable level in many cases. Against the background of secure interest rates, which continue to fluctuate around zero, risk premiums have risen to new highs. A number of companies have valuations last seen in the 2008/2009 financial crisis or at the height of the European debt crisis in 2011, despite far better financials and an improvement in their intrinsic value since then. That is astonishing, but maybe factors that we fail to see at present will spring a negative surprise on us all.

Conditions are not ripe for recession

However, would-be pessimists should note that the causes of the next crisis will be different from those of the last two. The problems back then are no longer a source of surprise and should not have the same devastating effects thanks to the counter-measures that have been put in place. After all, the subsequent problems were due to the uncertainty about the potential knock-on effects resulting from the actual source of the crisis (knock-on effects on other banks, inability of solvent states to roll over their debt). However, our view is that the (financial) world has become far less risky and therefore more sluggish – in both directions. Naturally, as ever in recent years, our view is tempered by the proviso that it is not clear how China will develop given its inflated debt. However, that would not affect shares that have nothing to do with China, yet they have also dropped sharply. Consequently, the assumption that the market, in its wisdom, is an indicator of potential problems there falls somewhat short of the mark.

There were a number of reasons for last year's downtrend

So what caused the downtrend in 2018? In our view, it took place in several steps.

The rise in US interest rate, which lifted yields on long-term treasury bonds above 3 % and also resulted in an end to negative real interest rates at the shorter end of the market for the first time in many years, was evidently seen by some investors as a good reason to adjust their asset allocation. Why take risks in a foreign currency (from the US viewpoint) and invest in volatile assets into the bargain, when the money could be invested stably at home? In Germany, replacing such outflows by domestic investment has been an illusion for many years, and even in other parts of the world it is not so easy. The emerging markets were the weakest link. The most visible example is Turkey, which has a clearly senseless economic policy and is also dependent on foreign capital. However, it is not alone: it is closely followed by the European markets, which have also failed to build enough trust.

In the second phase, this was exacerbated by global political uncertainty, even in developed

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countries, examples being Brexit, Italexit, and the US trade war with the rest of the world. Europe evidently had no intention of lagging behind: the clearly over-hasty introduction of the new WLTP process to measure automotive emissions put so much pressure on the whole sector and its suppliers that the costs run into billions and have to be borne not simply by their shareholders, but also by the state, especially in Germany, without bringing any perceptible environmental benefit. Pushing through senseless decisions seems to be *en vogue* – even for those whose name is not Trump.

Normally it is said that politically driven market movements are short-lived. However, this time the adage has proven incorrect: we were not faced with a short-term government crisis or the like, but by fundamental issues affecting the long-term fortunes of companies. In particular, that revived questions such as whether the chosen locations are still the right ones, how to handle investments and how trade might work under these new conditions. Although this has not yet had a major impact on the real economy, its effects are already affecting financial market sentiment as the inability to estimate uncertainty is offset by valuation discounts. Topics such as WLTP should gradually drop out of the valuation base, but the initial damage wrought by them – and by the introduction of customs tariffs virtually overnight – has already been done. The uncertainty will overshadow the financial markets until the trade rules have been clarified.

While all that is anything but good, it could be coped with over a longer horizon. However, the market then took on a momentum of its own, which resulted in the sharp drop in share prices in the last quarter of the year. The rising uncertainty caused by the above developments put risk avoidance strategies back at the top of the agenda. The cracks in the markets that had appeared by late summer widened and there was a complete collapse in the final quarter, when many investors had initially expected the usual rebound from a lower price level. This time as expensive quality stocks, which had previously escaped the trend, were affected along with the broad mass of the market. Apparently, the motto was get out while the going's good. There were, however, two important exceptions: shares that benefit from low interest rates and those that everyone previously considered toxic such as VW.

The trend culminated in the weakest December on the US stock market since 1931, with a sell-off of the previous bull market leaders such as the widely popular FAANG stocks, and a particularly surprising 3 % drop on Christmas Eve, followed by a 5 % rally on December 26. That brings us to another important factor: on December 24, those investors who are actually at work do not normally trade significant volumes; they tend to have their minds fixed on Christmas celebrations. That is not just a Christian phenomenon: the background is that the portfolio adjustments have been completed in the previous weeks, normally even before the start of December. It therefore seems fairly clear that this battle was fought by machines.

The growing influence of algo trading probably exacerbated the trend

That is clearly an important aspect and one that has a growing influence on the markets. Programming computers to act as traders is already widespread. They do not act emotionally and in theory their actions are completely rational. Provided they have been programmed correctly. Unfortunately, the trading parameters frequently seem to be similar: we assume that they are normally based on trend-following

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models. And the trends are then followed until the bitter end, and then shoot beyond the sustainable valuations again in the wake of the next trend reversal. Until they reach the bitter end again. That does anything but stabilise the market, but it can open up opportunities. Provided that one is aware of their influence.

Stabilising factors have become less significant

By contrast, two important stabilising factors have been more or less wiped out. Firstly, own-account trading by banks and other market participants, which did not always trend in the same direction, even within the same institution, and therefore had a stabilising effect. Even more significant is a second aspect, which is also partly due to regulatory factors: the risk tolerance of many institutions has evidently been undermined by low interest rates in recent years. Shares would normally be considered a reasonable alternative when interest rates are low. However, in many cases it seems that the opposite is now true: it is no longer possible to hold shares because of their volatility. For example, in the past if the interest rate was 5 % and 20 % of a portfolio was invested in shares, there would have been 20 % leeway for possible price declines on the shares, without affecting the nominal value. Today that leeway is virtually non-existent.
If institutions subject to such restrictions nevertheless invest in shares, they are evidently often forced to sell them when prices drop, instead of using the price declines to buy shares. Which reinforces the trend.

Therefore, there is a tendency to shy away from these volatile assets and concentrate on investments whose price can, ideally, be reviewed conveniently once a year (and where necessary adjusted to investors' needs). Given these conditions, many investors no longer act as stabilisers; on the contrary, they increase volatility further because of the lack of scope for compensation, and therefore strengthen the trends. That is our view and our explanation of the sharp correction in share prices in the fourth quarter of 2018.

The rising significance of volatility for many investors actually misses the real risk of investment: the risks of the company's actual business and the uncertainty about its sustained value. In our opinion, that is the reason behind the record rise in the risk curve. Low return requirements for everything that appears to be stable, even if it means erosion of assets in real terms. And record-high risk premiums for investments that are deemed to be risky.
For a large number of investors, it now seems that the benefits of fungibility, which result from a stock market listing, are overcompensated by the volatility resulting from share prices. Which can be a big advantage for those investors who can sit out or even utilise volatility.

Our outlook for 2019

What are our expectations for the year that has just started?

The decisive factor for us is what markets price into individual shares. In common with all market participants, we cannot foretell the future. Therefore, the key question is whether the expectations are realistic. Naturally, performance could be extremely positive or extremely negative. However, generally it is somewhere in-between. And here there are once again very attractive investment opportunities in both relative and absolute terms. As we have said: in many cases, present share prices would only be justified by a sustained profit recession.

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In our view, the correction is already well advanced. Technically, a correction rolls once through the entire market, starting with the emerging markets, followed by small and mid caps that were previously very popular in the western industrialised countries, then quality titles that are not driven by interest rates and previous star performers and finally the shares that drove the rally, aka FAANGs. At the very least, we are in the middle of the final chapter of the correction. It remains to be seen whether the lows of December will be tested again or whether prices might even drop below them. At any rate, it is striking that the equity markets that entered the correction phase first have not dropped to new lows, while some are already showing a perceptible uptrend.

We do not expect the weakness of recent months to be the start of a sustained and serious economic downswing. For that, the conditions are not the same as in the past: there is no overinvestment, banks are strongly regulated and have had little scope for senseless investment, valuations are not absurd (with the exception of non-interest-bearing sovereign bonds), monetary policy is not restrictive, there is no serious austerity and commodity prices are not skyrocketing. Consequently, we regard the weakness simply as a correction, with lower profit expectations responsible for about a third and lower valuations for about two-thirds. In the USA, valuations may previously have been above-average in historical terms, but that can be justified by the low interest rates and the high quality of large caps. In Germany, however, the overall market valuation was at most normal at the start of the correction. Relative to interest rates, it was low by historical standards, possibly due to the altered conditions outlined above.

Considerable opportunities as a result of the correction

Assuming there is no crisis, the question is whether we expect there to be a shift in the lead sectors. It is too early to say. Many “traditional” shares, especially in the cyclical camp, are significantly undervalued in our view. We assume an uptrend in this segment if the markets stabilise during the year, so the undervaluation could narrow. However, risk aversion is likely to remain high in view of the factors outlined above and recent experience, so there are good reasons to assume that quality stocks will continue to enjoy a high premium compared with “standard stocks”, especially if they remained stable during a phase of uncertainty. Consequently, we do not see any clear picture here. Our view of the market as a whole is different: here, we believe that the correction has brought considerable opportunities.

Sincerely yours,

M. Wirth

Martin Wirth

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