Our assessment of the current market situation and our positioning

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Dear investors, dear friends of FPM AG,

In our eyes, the war started by Russia in Ukraine will mark a turning point in history, the significance of which can only be rudimentarily predicted today.

As far as the war itself is concerned, everything is open in terms of severity, duration, possible escalation, spillover to other regions of the world and other aspects. We do not want to comment here on the human suffering and the political turmoil of these days, even though we have a firm opinion on the matter.
The sole purpose here is to give our assessment of the aspects that are relevant for the stock market from our point of view.

First of all, fundamentally: for 20 years, one crisis has followed another. From the bursting of the TMT bubble, the world financial crisis, the euro debt crisis, the shake-up of the global trade order to the Covid-19 pandemic, the crises became more and more existential.

Ultimately, only a global conflict and a comet strike remained. In these two cases, one no longer has to worry about investments, not even about the security of liquidity. But one level below that, like a war in Europe, we do. Because all crises of the last 20 years brought higher volatility, but regularly ended in new highs on the stock markets.

What we do not know, but what is economically relevant:
- Will the energy supply remain stable?

- What is the impact of the sanctions, also on the West?

- Which supply chains will face difficulties?

- Will logistics hold up in an economy based on the division of labour?

- How will the prices of raw materials develop in the medium term?

- How will companies deal with these problems?

- Is a global food crisis looming?

All questions that if answered correctly could be profitable. However, we are all limited in this respect. But, to quote the philosopher and ex-US Secretary of Defence Rumsfeld: We must first know what we do not know. And then consider what is priced into the stock markets. To do this, it is eminently important to understand how a company works in the first place.

I have just learned that a large German machinery and plant manufacturer has only in recent years included a force majeur clause in their contracts. This can be very relevant if one cannot deliver, for example, if semiconductors are missing, the production of which depends on the availability of a special gas, 50% of the world production of which takes place in Ukraine.

Avoid real asset losses

So let's stick with what we know: First of all, it is hard to imagine that inflation rates will move in any way to the levels assumed by the bond market and short-term interest rates. Given the pressure on businesses and consumers, central banks are likely to be reluctant to raise interest rates. Real asset erosion should thus accelerate, even if bonds and liquidity naturally look more stable in the short term than fluctuating equity prices.

At any rate, in our opinion, this tried and tested hiding place is no longer one at the moment. And thus it is better to be invested in real assets than in nominal ones. With the various distortions, however, it is also probable that a recession has become more likely. It is not based on a weakening of demand, as is usually the case, but, as was the case after the outbreak of the Covid-19 crisis, on distortions on the supply side. And would thus be quickly overcome if the general conditions were to normalise. So one should check one's nerves, but in the medium term equities are almost necessarily superior to bonds.

Precise knowledge of the business model is essential

What we know from our equity investments or what we want to be compensated for in the form of a lower valuation are questions like these:

- Can companies pass on the cost increases?
- How stable is demand? Is it possibly being displaced by general inflation?
- How easily can goods be substituted?
- What are the risks on the procurement side? How long does it take to build up contingency solutions?

- How important is business in the belligerent or sanctioned countries and in those close to them? This question is often at the center of attention, as it is the obvious one, but also the easiest to answer.

One thing is absolutely certain: we do not invest in companies from countries whose legal system we do not consider to be free and reliable. We accept when portfolio companies are active in these countries, after all, these are usually growing economies. Once again, one can see why this presence does not always have to be advantageous. Specifically in Russia and Ukraine, the companies in which we are positioned operate on a very manageable scale, rarely exceeding 3% of turnover, and even in these cases often in separable business units.

As far as possible, we try to create a balance in the portfolios that contributes to stabilisation even in different framework conditions, provided that the valuation of a company does not anticipate the best-case scenario. Thus, we were also invested in extremely undervalued defence companies - in contrast to the political position that has prevailed until recently- because in our eyes the world is what it is and does not always conform to the obvious perception of many politicians and media through rose-coloured glasses. The same applies to manufacturers of fertilisers, agricultural corporations or companies in the energy sector. Because the world just is what it is! Negating this can have undesirable consequences: Lack of energy security, lack of external security, lack of cyber security.

In the coming weeks and months, from our perspective, the world will get used to war or the situation in some form or another. It is only because of this that the human species has become so successful: The ability to adapt is outstanding, and there is nothing morally reprehensible about that, it is simply given to the human being. Life will go on in large parts of the world, and Russia, Belarus and, as the case may be, Ukraine will go their separate ways. Thus 97% of the world economy will function as before, with the essential risk of energy security and food supply. But as I said, the species is adaptable.

What can happen?

There are many companies that have exactly zero to do with the aforementioned countries, but whose shares have nevertheless become considerably cheaper. The valuation of the German stock market was already attractive to a large extent before the crisis, now it is even more so, assuming a normalisation. It is unclear how much liquidation is still needed, whether there will be a recession, how high inflation rates will rise. But this is always true, even if one thinks otherwise. What is astonishing, however, is that given the dimension of the threat - mentioned again: war in Europe, refugee flows, exploding commodity prices, the threat of a nuclear bomb being used by Russia - it is quite astonishing how little the stock market is impressed by it, apart from punished formerly very popular growth stocks. This is not about a burst TMT bubble, this is possibly about existence.
And thus the comparatively subdued reaction of the equity markets can only be interpreted as a sign of strength in our eyes. At least in comparison to nominal asset values.

Perhaps it would provide some clarity to look at the options Russia now has and their threat potential. The use of nuclear bombs is beyond any investment consideration; on the other hand, it is the guaranteed downfall of Putin's rule. Attractive perhaps for a nihilist, but that's apparently not what he wants to be as the new tsar. In addition, conventional armed forces as well as cyber war: the first with an unclear, but even in the best case (for him) a very long-term option to achieve the goals after the positioning of the West. Cyber war unclear, not taken seriously for a long time, but that, like many things, has changed. Annoying, but probably not existential. What remains, perhaps realistically the most feared option, is the threat to cut off energy supplies to the West: Here, above all, Europe will be hit at its most vulnerable point in the short term. On the other hand, as we can already see, this shot will also backfire: Once the reliability of Russia as a supplier of a commodity that is systemically important by all criteria is called into question and alternatives are built up, then part of the business will be permanently lost. This can be partially compensated for in a few years' time by the massive expansion of renewable energies, but also by making greater use of other suppliers, which is more expensive and painful, but should be feasible. In this respect, it is understandable that Russia is finding it very difficult to pull this card. It would be the economic nuclear option. There is, after all, the first day after the war, even if it obviously does not come as quickly as Putin had planned. And then you realise: the customers are gone.

To introduce a positive perspective for once: The attitude of the West has been since the end of the Cold War comparable to the principles of anti-authoritarian education. Everyone is allowed to do what they want, everyone has their own standards, and if things go well, this leads to a colourful, diverse community. But if a member of this community permanently violates the rules, this will eventually lead to consequences, just as it did in kindergarten. After multiple crimes against humanity, all of which were accepted, one line too many has now obviously been crossed. Putin obviously did not expect this, just as he did not expect other surprises. This does not mean that Nato would actively intervene in the war. What it may mean, however, is that the mischief Russia has brought upon a large number of states will not be tolerated in the future. To name: Afghanistan, Syria, Eritrea, mercenary troops in many countries, ammunition of authoritarian regimes, fighting democracy in many countries, etc. are the sad truth. This also includes assisting in the suppression of the Arab Spring. Sadder only that this was accepted by the Western community of values. And this list is far from comprehensive. And so that no one gets the idea to reproach the USA and the West for their wars that violate international law: International law and human rights are two different things. Those who do not want to recognise this put criminals like Assad and Saddam Hussein on the same level as the Ukrainian president. And they portray themselves as completely ignorant. What looking the other way leads to was seen in 2015, and now the war is taking place on our doorstep. This in no way means that military conflicts will increase, quite the opposite: values that are consistently enforced have a better chance of being accepted. Especially if the bribed "useful idiots" in Europe and elsewhere no longer act in Putin's interests. The world still has a lot of potential. Putin and his regime have gambled high in recent years and always won because no one was willing to go along. Now the other side wanted to see his cards for once. We will find out what they are. From the feeling, not much more than a pair of 7s.

Our positioning in the portfolios

Back to investing these days. Given the ambiguities, we have decided to make only incremental changes, ruling out a wholesale shift into defensive stocks, most of which have unattractive valuations and muted growth prospects. As in past crises, we have not hedged using derivatives. We consider the portfolio positions to be low valued. Hedging means nothing other than the economic sale of these positions. What criteria should then be used to buy back? Waiting for peace? Lower oil prices? Then one might have missed out on a lot. We will keep our aforementioned hedging positions armaments/food/energy for the time being, but they do not dominate the portfolios. We may see a fundamental change coming to the world, and these companies should continue to benefit from that, even if there is an easing of tensions in Ukraine. A hedge that can also be profitable in its own right is particularly pleasant.

Currently, the FPM Funds Stockpicker Germany All Cap and FPM Funds Stockpicker Germany Small/Mid Cap funds have lost about 4-7% less than their benchmarks this year. Based on the last 20 years, we have the expectation that there is a good chance to further extend this outperformance in a recovery scenario. We will avoid the favourite hiding places of risk-averse investors: With rising inflation rates, they could turn out to be toxic.

Yours Martin Wirth