FPM-Comment **Reducing the Noise**

Martin Wirth – 3/2017 dated July 11th 2017

In times of the subsiding fear bubble

Martin Wirth – Fund Manager, founder and Member of the Board FPM AG

- Experience in German equities since 1990
- Funds: mutual funds FPM Funds Stockpicker Germany All Cap, institutional special mandate for NBIM

- The first half of 2017 was solid to good – in our case good
- Europe: more light than shadow
- Turnaround is continuing – fear bubble is subsiding
- Old favourites underperform, other stocks post growth
- Conditions are still good for our favourites

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Review of H1 2017

By and large, the performance of the German equity market was solid to good in first half of 2017. In fact, the price performance of the FPM funds was considerably better than the market, with clear double-digit gains in some cases. This was due to an excellent performance by individual equities, some of which had previously been trading on extremely low valuations despite their solidity. In addition to company-specific developments, these shares benefited from two overlapping trends: stabilisation of inflation forecasts and central bank policy geared to normalising monetary policy in the coming years, plus the generally sounder economic development that is now also becoming evident in previously problematic parts of Europe.

Overview of Europe

Here is a brief overview of the situation in Europe: amid all the fuss about the manifest incompetence of the Greek government, which neither will nor can deliver, it is amazing to note that Portugal, for example, has started to repay its debt to the IMF. So a reasonable consistent approach obviously does work. Following French elections, there is a possibility that meaningful reforms will be introduced here as well. The only problematic country of any relevant size is now Italy. The structural problems there are unlikely to play a role in the present cycle as there are signs of improvement here too, and the ECB and EU still have no wish to spoil the party.

The dominant trend in the near future is therefore likely to be the increasingly broadly based upswing that has emerged in recent quarters, supported by the stabilisation of the banking system. As well as a significant improvement in the capital base in the banking sector, it is gradually becoming clear that the positive development of lending will not be choked off by further tightening on the regulatory side. Globally - as in Europe - there is no impressive growth to be reported. That said, the distortions triggered by the commodity markets in particular have now been checked and are no longer a direct stress factor.

Financial markets: trend reversal on key issues

What does this mean for the financial markets? The key issues affecting the markets in recent years could be exposed to an ongoing trend reversal. The overriding trend was the flight to safety, which we feel led to a bubble in investments considered safe and deflation of those considered risky. As a result, the valuation spreads between the various segments widened massively. This happened to currencies, interest rates, issuers with different creditworthiness and naturally also in our sector, the equity market. Starting last year, the situation turned and this trend has continued up to now, albeit with the occasional setbacks.

Although most market observers predicted parity between the US dollar and the euro, the dollar is no longer in such high demand as a safe haven. However, it remains considerably overvalued as a result of purchasing power parity. Interest rates on US treasuries and German government bonds have risen, in the case of German bonds despite further purchases by the ECB. Inflation expectations remain low but have also stabilised. This has led to considerable underperformance of "safe" equities over the past twelve months. That applies, first and foremost, to shares in stable sectors such as healthcare and real estate. In recent months, the circle has widened to include shares in cyclical but high-quality companies: following a grandiose performance by some, companies with this profile have started to weaken. By contrast, since the middle of last year, there has been a strong rally in companies that were hit by the low interest rates, e.g. those whose pension obligations had ballooned (as a result of low interest rates), cyclical stocks with a mixed short-term track record and financial stocks. In these cases, the flight into perceived quality in recent years led to massive undervaluation, which has now started to correct.

Sometimes it only becomes evident which stocks are quality stocks when conditions change. Some equities that are now regarded as first-rate were perceived quite differently a few years ago for a variety of reasons. Therefore, alongside the high valuation of some stocks, we see a risk that conditions could change again, showing that their quality is not what it was perceived to be during the fear bubble.

Our favourites have price potential

In our view, sustained stabilisation of the present situation would be sufficient for the average stocks that we favour to continue to outperform. Even though interest rates are currently extremely low by historical standards, these average stocks are still significantly undervalued. If the economic recovery continues, coupled with a further gradual rise in interest rates, the undervaluation would only become more evident.

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

It is important to be aware that this will also be accompanied by counter-trends. And that it will take place at about the speed with which glaciers move. However, as we have seen, such trends can last for years and lead to massive shifts in valuation. We believe that the reduction in the fear-induced risk premium is only just starting. Nevertheless, we would like to reiterate that, even if the present conditions do not alter, we see sufficient price potential for the upcoming quarters, based on the existing valuation spreads.

Sincerely yours,

M. Wirth

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