FPM Comment **Reducing the Noise**

Raik Hoffmann – 2/2017 dated 01.06.2017

We are happy to repeat ourselves: all the indicators still favour equities

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- Fundamental environment for euro-zone equities is still better than perceived by the media
- Speculative bubbles on the bond market and in some related asset classes
- Growth expected to be stronger than generally anticipated – partly based on insights from our discussions with companies
- Pressure to normalise monetary policy increasing by the month
- Since summer 2016 portfolios have been systematically aligned to the beneficiaries of higher interest rates and/or stocks where constant interest rates are priced in

Indicators are pointing upwards – but the media is overwhelmingly sceptical

The fundamental economic situation for equities in the euro zone is sound. For example, we have noted a positive credit cycle and higher purchasing power resulting from higher employment. Nevertheless, the upswing is accompanied by a good deal of scepticism, which we find astonishing. The election of Trump, the French elections and elections in Italy in the near future. And if there is nothing left to feed the scepticism in our hemisphere, attention turns to North Korea. Strange though that the Korean equity market (KOPSI) has started to rise after many years of consolidation – although Seoul is within reach of North Korean artillery. Somehow, there seems to be a dichotomy between how the risks are viewed locally and how the media report them in Germany. And then there's the threat of an impeachment process against Donald Trump. That would naturally by HUGE, if it weren't for the fact that his possible successor is Mike Pence, who would probably be far more predictable. TREMENDOUS. Evidently, tax cuts or programs to stimulate the economy would, at the very least, be postponed. But would that be so bad?

Facts suggesting that there will not be a stock market crash

In the past, stock market crashes were preceded by speculative bubbles, a sharp hike in oil prices and/or rising interest rates (the last two of which were often linked).

In our view, there is absolutely a speculative bubble on the bond market, and – more or less developed – a bubble in related asset classes such as (or in some areas of) the real estate sector and shares in companies with above-average earnings quality (bond proxies). While there is some speculative cheerfulness in a few shares, this definitely does not apply to the entire German equity market.

We also appear to be shielded from the risk of a sharp hike in oil prices, at least in the foreseeable future. The prospect of a speedier switch to electric vehicles, increasingly cheap energy from renewable resources (in sunny regions, solar power generation now costs € 0.03 per kWh), the chronic financial difficulties in almost all oil-producing countries and the fracking industry in the USA, which is a swing producer, all indicate that a sharp rise in oil prices is relatively unlikely in the near term. The only remaining risk factor is therefore that interest rates could rise stronger.

That said, in the foreseeable future we do not expect interest rates to rise to levels that would be appropriate for the current economic development. Nevertheless, it is amazing that the investment consensus finds it almost impossible to imagine rising interest rates. While short interest in T bonds in the USA was at a record level at the start of the year, it has now reverted to a very high net long position. Leaving aside the now typical Q1 weakness in the US economy, growth rates are quite pleasing around the world. The purchasing managers' indices for Europe, which actually posted a further rise in May, have been indicating GDP growth of 3 % for months, at least insofar as the past high correlation is still valid today. The ifo business climate index being at the highest level since 1991 (reunification boom!!!) – speaks volumes. Moreover, high index levels for the current situation and relatively low index levels for business expectations show the engrained scepticism for whatever reason. Although the sentiment indicators are good, 2 % growth in the euro zone is the most the economists can conceive of. The pessimists and those who have been predicting a correction for months can naturally take the view (probably with some justification) that from now on the macro surprises can only be negative. But perhaps the truth lies somewhere between the two and growth will be better than expected, even if the sentiment indicators weaken. At any rate, that is what the figures and the comments from our discussions with companies suggest.

Pressure to normalise monetary policy increasing by the month

Be that as it may: at present, neither key interest rates nor bond yields match the broadly based economic upswing that we are currently seeing in the euro zone. According to the Taylor rule, a monetary policy rule used by central banks to set interest rates, the key interest rate for Germany should be around 6 – 7 % (!)

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at present. Even for the euro zone as a whole, interest rates are already too low, while for Italy they would have to be far lower than they are at the moment. The ECB will never be able to please everyone, and some countries such as Italy and Greece provide arguments as to why the ECB will try to press ahead at full steam for as long as possible (even if implementing reforms would be more effective). However, every month, in which the economy recovers, unemployment falls and there is a successive rise in inflation, will pile on the pressure to normalise monetary policy, if only because the negative repercussions of a zero interest policy (e.g. lower profits at banks, negative impact on pension funds and possibly greater efforts by individuals to save for retirement, increasingly speculative investments by many investors, etc.) will increasingly gain the upper hand, especially relative to the expected positive effects. Whether that takes three months or six months is irrelevant. The markets will anticipate it early on and exchange rates are already starting to respond. Instead of the widely predicted parity to the US dollar (or even slightly lower), the euro is suddenly starting to appreciate (incidentally, current account balances favor appreciation). A similar situation is seen against the Swiss franc.

Central banks around the world will doubtless endeavor to switch to a more restrictive monetary policy too slowly rather than too fast. The ECB will most likely wait as long as possible but it will probably gradually take its foot off the accelerator in 2018, and is likely to announce that at the latest by autumn. The Fed will continue to use every reason to proceed slowly and in this respect a US president under fire could buy time. Massive tax reductions (preferably on credit) and a big infrastructure program would probably result in considerable inflationary pressure in the current economic situation in the USA, i.e. quasi full employment with rising wages, and possibly put pressure on the Fed to raise interest rates more quickly.

Anyone who still expects yields to drop against this background needs consider the prospect of an immediate recession. In the best case, yields could remain unchanged, but probably only for a few months. Higher inflation means that real interest rates have fallen further in many places despite the rise in nominal rates and are actually negative in some cases. Monetary policy in most major countries is therefore still extremely accommodating or has become even more accommodating. If all market players wake up simultaneously, as they did last autumn, interest rates could well rise slightly faster. A one-percentage point increase in long-term rates may not sound very dramatic, but it depends whether rates rise from 5 % to 6 % or from 0 % to 1 % and the corresponding mortgage rates rise from 1 % to 2 % (which means that interest on mortgages would double). We also find it difficult to judge how strong an impact rising interest rates would have and, above all, where the pain threshold would kick in on the market. We are charting new territory with extremely low interest rates and that is no doubt one reason why central banks are taking an extremely cautious approach.

Positioning of our portfolios

However, we prefer to be "rather early than sorry". Since last summer we have therefore been systematically aligning our portfolios to shares that will benefit from rising interest rates and/or are already trading at such a low level that unchanged interest rates are already priced in (e.g. banks, companies with high pension liabilities). Moreover, we are avoiding investments that have benefited first

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and foremost from low interest rates (bond proxies). Although the valuation discount on these companies is no longer as big as it was last autumn, there are still very attractive investment opportunities in this segment. Above all, these companies should offer higher downside protection if interest rates should nevertheless do the unthinkable.

Sincerely yours,

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