FPM Comment **Reducing the Noise**

Raik Hoffmann – 4/2017 dated December 19, 2017

2017 and 2018: Review and forecast

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- 2017: Economic expectations have been fulfilled but interest rate forecasts have not
- We do not share the current Goldilocks consensus
- Equity markets have further potential
- Classic value shares are still more attractive than quality shares with predictable profits
- Absurd interest rate level makes no sense – we still expect rate rises
- Increasing volatility could open up new opportunities

"Forecasting is difficult, especially forecasting the future."

True to this motto, we endeavour to analyse the three criteria of relevance for the future of a company and its performance (business model, management and valuation), without having to predict what the future will bring. Companies that have a stable and successful business model, a conservative, shareholder-focused management, and a favourable valuation will survive short-term phases of politically driven market uncertainty or even recessions and generally emerge stronger. Moreover, they will generally rebound from price setbacks within a reasonable timeframe. However, since we naturally also consider the present capital market situation, we would like to give you some insights into our expectations for 2018, as is customary in the sector. But first, a short review of 2017.

Our assumptions for 2017 - and how they fared

Our expectations of good economic conditions proved correct. We were quick to point out that the leading indicators (PMI, ifo) indicated far higher growth than the economic researchers expected. We also drew attention to the increasing synchronization of the global economic upswing. Since valuations were only expensive in parts of the equity market ("bond proxies") and otherwise equities were in some cases

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extremely cheap, we predicted a good year for equities. Naturally, we are particularly pleased that it turned out to be such a good year for our investors. By contrast, our interest rate expectations proved quite wrong. We had firmly anticipated rising interest rates. Since economic growth turned out to be even stronger than expected, this would have been even more logical. However, the fact that "financial conditions" became even more accommodating, even in the USA against the background of full employment and a central bank shifting towards a more restrictive monetary policy (interest rate rises), speaks volumes and shows that the liquidity created by the ECB and BOJ is still flowing around the world. Nevertheless, we were able to handle that because our portfolio structure meant that only a further drop in interest rates would have had an adverse effect (bond proxies as winners). We were also surprised by the extremely low volatility (especially on the US market).

2018: Economic environment for equity markets

Economic researchers have now raised their forecasts a number of times. The expectation of a synchronous upswing with low interest rates and correspondingly low volatility is now the consensus – Goldilocks forever. We have a number of reservations about that view. But first things first.

Basically, the economic environment remains very positive. Although the high economic momentum at the end of 2017 will almost certainly not be sustainable, almost all the ingredients of a recession are missing, especially overinvestment, central banks applying the brakes, not to mention inverted yield structure curves. Therefore, profit trends should continue to point upward and the equity markets, which – with a few exceptions – are basically fairly valued, should have further upside potential. Conventional value stocks, which have been our favourites for a long time, should still have more potential than quality stocks with extremely predictable profits, but the valuation spreads have narrowed somewhat and are therefore less pronounced than they were a year ago.

The only thing that could spoil the party is China, which has again stepped up its efforts to check the debt orgy. As always, we do not feel competent to shed more light on the Chinese black box. We prefer to leave that to the experts, but nevertheless keep our eye on certain parameters in the Chinese economy so we can detect problems in time. Our gut feeling is that, given the global upswing, it is difficult to imagine potential problems escalating at present. China will probably slow the present strong global growth momentum slightly and continue its efforts to check credit growth, insofar as there is scope to do so. Therefore, we believe the outlook for the stock market is still good.

Low interest rates lead to alignment of risk profiles of equities and bonds

That said, the central banks have created a situation that has significant implications: with "zero-bound" interest rates, little or nothing can be earned on bonds (in fact, returns on short maturities are actually negative) but a considerable (and rapid) loss is in the offing if rates rise ("negative skew"). That means the risk profile of bonds is moving into line with that of equities. Consequently, equities no longer need a risk

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premium compared with bonds, and equity valuations have corresponding upside potential. Since this evidently cannot be calculated exactly, and investor preferences determine this new "equilibrium", we are charting unknown territory. However, this is a relatively good explanation for the low-volatility environment and rising valuations. If interest rates remain at the present level, the outlook for 2018 is pretty good and there would probably be further scope for higher valuations, especially for German and European multiples which are low compared with the USA.

Yet that is contingent upon interest rates remaining where they are at present. Even though our expectation of higher interest rates has been wrong for some time, the absurd level makes no more sense than it did a year ago. With GDP growth of around 2% and inflation at about 1.5%, German bond yields should be closer to 3.5-4% than to 0.3%. But they are not, thanks to ECB & Co. Nevertheless, we need to ask what indicates that yields will remain unchanged or even drop. Not much – apart from the conceivable possibility of a substantial slowdown in growth (which would probably also be unfavourable for the markets) and declining inflation rates. Is that realistic?

If the low inflation rates are explained by the output gap (if there really is one), this would decrease rather than increase with every month in which growth is reported. It will be interesting to see what the outcome of the German pay rounds is, but it seems unlikely that there will be a 2 in front of the decimal point. If the USA pushes through its tax reform this year, it could fuel rather than dampen inflation given the maturity of the economic cycle and quasi full employment. We will have to wait and see whether the accelerated depreciation options actually trigger a slight investment boom. However, from talking to companies we consider this to be a plausible theory. At any rate, it could be true for smaller companies in the USA. Big companies will probably repatriate their foreign assets on favourable tax conditions and buy back shares. At least this would increase earnings per share, which would not be held back by depreciation, thus boosting bonus payments to top managers.

Central bank policy

At the same time, central banks are pumping less and less money into the market. The ECB is halving bond purchases in January, the USA is reducing bond holdings and the Japanese will probably follow their lead. If the ECB halts its bond purchases or at least reduces them significantly in autumn, it seems highly probable that purchases by the major G4 central banks will slip into negative territory from autumn 2018 (owing to the reduction in the Fed's balance sheet). Moreover, at some time people will start talking about the end of Draghi's term of office, even though October 2019 still seems a long way off. However, an ECB policy and forward guidance that bear his mark so strongly are only credible while he is still at the helm. It is not entirely improbable that Draghi could initiate some degree of normalisation so that he does not go down in history as the biggest printer of money (at any rate, that is what I would do if I were in his position ☺). It may seem doubtful that he will be succeeded by a German, but after a Dutchman (with an affinity for Bundesbank policy), a Frenchman (with a more southern mentality) and now an Italian (which speaks for itself), it would seem to be time at least for a candidate close to Bundesbank policy.

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Since the bond markets only react like lemmings to actual rises in inflation (see last year, when a predictable increase in inflation rates triggered a rise in interest rates in H2), this could prove a further drag on the bond markets. For the USA, at any rate, it is fairly easy to predict that inflation will rise in Q2 due to the reference base. On an annualised basis, this will reflect the dramatic drop in mobile communication charges in the USA on the one hand, and the impact of the weaker dollar on import prices on the other. Core inflation in H1 2018 could thus move towards the Fed's target and normalisation of monetary policy could continue with several (four?) interest rate hikes in 2018. The situation in Europe may look different but it seems relatively unlikely that interest rates in Europe will not react at all to US rates.

Outlook equity markets 2018

The arguments against a continuation of ultra-low interest rates in Europe and the USA are increasing: declining unemployment rates and thus a lower output gap (insofar as there still is one at all), a clear rise in inflation in some cases, and a successive slowing of the increase in central bank balance sheets, giving way to contraction in H2 2018. In view of this, it is unlikely, but not impossible, that in 2018 interest rates will remain as low as they are now. In the USA, there could be a 3 before the decimal point again, which could increase equity risk premiums and trigger corresponding pressure on valuations.

All in all, the equity markets should have further potential in 2018, although this is likely to be accompanied by increased volatility as a result of higher interest rates - including a bigger correction than in 2017. Interest rates are doubtless the biggest threat we can identify at present. However, if the equity markets drop sharply, the central banks would postpone normalisation, which would put pressure on interest rates and support equities. Looking at the present market situation (bitcoins, high yields, plus some areas of the equity market and fashion IPOs that are massively oversubscribed and price in business expectations for three to four years), the market could be placed on a sounder basis again, opening up new opportunities for active investors.

Sincerely yours,

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