FRANKFURT PERFORMANCE MANAGEMENT AG

FPM-Comment **Reducing the Noise**

Martin Wirth – 2/2018 dated April 10th 2018

Why Q1/2018 is likely to remain an intermezzo ...

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

- Spike in volatility put pressure on the equity markets
- Growth rates look set to normalise in 2018
- What happened in Q1/2018 was caused by inherent market mechanisms
- Generally, volatility is defined as risk – we define the possibility of a permanent loss of capital as risk
- Investors are settling back into the old patterns of behaviour of recent years
- Equity markets will adjust to the normalisation of volatility in the near future
- No leading indicators pointing to recession; the consolidation will probably end in the coming weeks

Review of Q1/2018: Spike in volatility put pressure on the equity markets

Following the initial price rises, the first quarter of 2018 turned out to be less positive for the German equity market, which sustained broadly based losses. The FPM Funds suffered disproportionately heavy losses, which eroded some of last year's strong outperformance. The only exception to this was the FPM Funds Ladon, an equity-oriented fund with a total-return approach: systematic hedging enabled this fund to defend most of its year-end price levels. As anticipated at the start of the year, volatility increased on the equity markets, driven by last year's rise in interest rates, expectations of further rate rises and - the factor that caused the massive downside pressure on the German equity market - the strength of the euro.
The resulting increase in volatility took on a life of its own, with price fluctuations backed up by a negative news flow. Since the real economy continued its positive trend, the valuation of many German equities has dropped back to a level that implies either a considerable economic slowdown or – conversely – above-average opportunities if no slowdown occurs.

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2018: Normalisation of growth rates

Last year's economic momentum has now passed its peak. That was almost inevitable given that the pace of growth exceeded the sustainable growth rate and therefore had to return to this level at some time. 2017 was the first year for a long time in which there was something like a sustained and broadly based self-supporting upswing in Europe. However, momentum cannot increase every quarter. Is that a problem? Not really, because the outlook for this year is normal cyclical expansion, with the economy, companies and corporate profits posting further growth. It would be a problem if there had been a massive bubble, either due to excessive equity valuations or to misplaced investment in the real economy driven by overly euphoric expectations. There is no sign of either, which is hardly surprising given the more cautious long-term stance in the wake of the financial crisis. At times, however, the declining momentum is touted as the reason for lower equity prices. Moreover, political uncertainty may have exacerbated the trend to some extent. However, this is normally only recognised as a problem ex post and then used to justify price performance.

Betting on persistently low volatility led to complete losses

In our view, the cause of the drop in prices and the general confusion is inherent to the financial markets. That needs some explanation: The low general risk appetite in recent years was also reflected by the financial markets. There was limited willingness to invest, despite the fact that high returns could be achieved because for a long time valuations had been attractive in both relative and absolute terms. However, what attracted capital over time was the declining volatility, which was increasingly regarded as being manageable. More or less ingenious financial innovations such as inverse volatility products were probably only the tip of the iceberg, but they are a good illustration of what happened: With these "products", it was possible to bet on/invest in falling volatilities (select whichever view suits you best). Since volatility declined steadily, the prices of these notes rose, attracting even more capital, which pushed their price up even further and therefore reduced volatility even further. What was presumably not clear to most of these "investors" was that such strategies are nothing other than selling insurance cover to third parties (for example, shareholders who hedged their positions, for example via options), at constantly declining insurance premiums.

General definition of risk ...

That doesn't sound clever and it wasn't: the hard truth hit in 2018. Following 2017, the first "perfect" year on the US stock market, without a single month in which the market made a loss, the relevant parameters have altered. The Fed has clearly opted for interest rate rises, long-term US interest rates have shifted to a more normal level, instead of drifting deeply into negative territory as predicted by the prophets of doom. These basic adjustments triggered renewed volatility throughout the system and chaos broke out in the wake of what was initially only a slight rise in volatility. The naive assumption of persistently low volatility was no longer tenable, the "insurance policies" were terminated, resulting in an surge in volatility caused

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by coverage of these positions, coupled with a massive rise in hedging prices. Positions that had previously been hedged had to be sold because they could not longer be held. That is perfectly logical if mathematical volatility is equated to risk. And that is how things are seen, not just by most market participants, but also by the regulators. As a result, in many models there was a perceived increase in the risk of equity investments. To maintain a given risk budget, positions therefore had to be reduced.

As a consequence, thanks to the increased cost of hedging, higher risk premiums are being demanded. Therefore, the present value of future cash flows, in other words, equity prices, will settle at a lower level. Assuming that the basic conditions have not altered significantly, this means that the expected returns have increased as a result of the higher risk premiums. (And if readers minds now jump to issues such as Trump, customs duties, Putin and Erdogan: remember how little is reported about China's readiness to address issues such as pollution, reducing overcapacity and debt or the changes in Saudi Arabia, which could potentially unleash considerable potential. Because prices drive news and not vice versa.)

... and our view of risk as value investors

In our view, which is commonly held by value investors, risk comprises a lasting loss of capital rather than price volatility. Risk may be expressed in price volatility but the principal factors are a dysfunctional business model, excessive corporate debt and, first and foremost from a shareholder viewpoint, excessive equity valuations. As we have said, volatility can be an indication of risk. That said, volatility may also be very high when equities are very cheap and therefore offer very high risk premiums, and at market turning points, when trends are reversing. At such times, volatility offers opportunities and the focus is not on risk avoidance. The trend reversal that is becoming evident now is a rise in interest rates and the attendant uncertainty about the expected interest rate level. But even assuming that in the future interest rates will remain low compared with recent decades, the situation is less favourable than in recent years for companies with a long calculated duration, in other words, a high valuation based on the assumption of high and/or stable growth rates.

This is where we see the risks

So, looking for the real risks, in our view, they are not currently to be found in volatility and probably not in the operating business of the majority of companies either. In our view, many of these risks have been widely discussed and should therefore be largely priced in. The increased debt level at some companies, as a result of major acquisitions for example, could become a problem if interest rates rise. However, that is largely ignored at present, making it a potential problem. The biggest risk, however, could be valuations in some segments of the equity market. Unlike the situation in recent years, this may not mainly apply to stable companies with predictable growth rates. Valuations of some of these companies fell considerably last year. Rather, it applies to companies with high growth rates over a long period of time. In these cases, the prices paid assume that growth will continue, which could lead to heavy losses if this does not happen. By contrast, companies regarded as more average are still - or have now become - cheap.

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Here, valuations have been reduced by fears of a deterioration on the operating side due to a recession or a significant drop in growth. That could happen, but it is no more likely than it was in recent years, even though some market observers are continuing to predict that it could - as they have been doing repeatedly for a number of years. As the saying goes: the market has predicted eight of the last three recessions.
Be that as it may, following last year's strong performance, shares in such companies have suffered most so far this year. In our view, this was principally due to profit-taking since their business performance has tended to be better than expected.

Investors: returning to old patterns of behaviour

How have investors responded to the change in market conditions? By and large, they have fallen back into the familiar patterns of behaviour of recent years: heading for safe havens, buying stable shares, investing in government bonds. Profit momentum has regained its dominant role in equity performance, while share valuations have become less significant again. That has probably been strengthened by the fact that many investors only jumped onto the bandwagon at the end of last year, evidently without much conviction, while it was still moving in the opposite direction. Therefore, money initially flowed into areas where quality indicates greater security in what are perceived to be uncertain times – completely the wrong reaction given the present facts, i.e. solid growth, an interest rate reversal and relatively low valuations of companies that are benefiting from these two trends.

Our assessment of the latest developments

What is it that makes us relatively sure our interpretation is correct? The fact that the price volatility we are currently experiencing is home-made and should not be seen as a sign of an upcoming economic slowdown. In addition to the fact that a clear economic downswing cannot be identified anywhere, that is due to the relationship between the increase in volatility and the price declines on the equity market.
The volatility normally measured in connection with market downswings, for example in the USA, would be four times as high as what we are seeing. That may sound esoteric, but in our view it is highly relevant: it was the hike in volatility at the end of January that caused prices to drop and not vice versa. As indicated above, in our view that was due to the fact that willingness to hedge risks for others for a relatively small sum disappeared from the market, triggering equity sales, which were caused by the fact that this type of "insurance policy" had become more expensive. When insurance becomes more expensive and decisions are taken to refrain from purchasing such cover, behaviour alters: on the equity market, the risk premium rises, resulting in lower valuations. Unlike the situation caused by structural breaks such as the shift from a bull market to a bear market, even after a few weeks of lower prices, profit expectations are still basically stable, apart from currency effects.

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In our view, the first quarter will prove an intermezzo. We assume that

- in the near future the equity markets will have adjusted to the normalisation of volatility, i.e. to the increase in volatility compared with the extremely low level of 2017
- there is no sign of a recession
- the presumption that the globalization trend could reverse as a result of political intervention is completely unrealistic
- interest rates cuts can be ruled out in view of the price pressure resulting from full employment in many countries, which will also affect interest rates at some time
- interest rate rises could become a problem for the equity markets at some time so the beneficiaries of lower interest rates should now be avoided
- although the upswing is already a few years old, permanent risk aversion means the time is not yet ripe for it to end. Incidentally, this last point – permanent risk aversion – is once again clear from the reaction of the equity markets.

Following the end of the consolidation, we expect the 2017 trends to continue

The global economy is stable and there are absolutely no leading indicators pointing to a recession. On the contrary, more and more indicators are rising to record levels. It is therefore correct to assume that a slowdown will occur at some time. However, it is highly unlikely that it will happen now or in the market-relevant future. Leaving aside some exceptions, companies and their profits are developing solidly, although at German and other European companies, this is evidently being hampered to some extent by the strength of the euro. Valuations are still absolutely fair across the board and valuation bubbles, insofar as there are any, have only formed for shares in a few first-class companies. Equities are cheap compared with bonds.

In view of the labour market situation in many countries, the biggest danger is that wages could rise faster than productivity in the not-too-distant future. However, there is little sign of that in the rich western states. The situation is different in those countries where many operations have been relocated to in recent years, for instance, Eastern Europe: here, wage rises are in double digits and there are often labour shortages. This is not simply an economic viewpoint: some German companies have already experienced this at first hand, along with the related costs. The wage arbitrage that has been going on for more than twenty years has checked wage rises in the “west”. It remains to be seen how long this will continue.

Given the possibility of a wage-price spiral and the fact that central banks tend to be behind rather than ahead of the curve, we feel it makes no sense to invest in equities that benefit from falling interest rates. Nevertheless, such shares were among the winners in the first quarter, alongside government bonds with high credit standing. We interpret that as a counteraction to last year’s trend. One can never be sure, but the valuation gap between the market segments has returned to a very high level, partly thanks to solid

profit trends at companies of more average quality. Consequently, we assume that the consolidation will come to an end in the coming weeks.

Largely fair valuations suggest an end to the correction

Therefore, we still consider that average shares are undervalued in both absolute and relative terms. In view of the valuation discrepancies, we assume that the first quarter of 2018 merely interrupted the outperformance since mid-2016, resulting in profit-taking but not a fundamental trend reversal. Nevertheless, it will take time for the markets to price in higher volatility across the board. This could be just a few days, a few weeks or even a few months. The higher risk premiums resulting from higher volatility lead to higher discount factors, which reduce the present value of all shares. Normally, a trend like this runs right through the market. We feel that part of the correction affecting the various market segments has already occurred and that it would be naive to hide behind the segments that have not yet been fully affected. And even when the process is over, there will not be a gong signalling the time to enter the market. Therefore we are basically sticking to what is considered the most reliable yardstick over time: valuations, which are fair for the majority of shares.

Sincerely yours,

M. Wirth

Martin Wirth

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