FPM-Comment Reducing the Noise

Martin Wirth – 3/2023 dated July 11th 2023

Things remain the same: Equity investments should continue to take first priority

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- Despite difficult conditions: Stocks recorded price gains
- Recession has been underway for quarters, in small steps
- The cautious sentiment reduces the risks
- Stable equity markets indicate low valuations given the environment
- Various aspects prove the attractiveness of equities

The first half of 2023 brought more or less significant price gains at index level, broadly spread across almost all sectors. However, the dispersion in performance was considerable. One could most likely conclude that the large-cap stocks were ahead. However, while this statement is correct on the one hand, it is not very illuminating on the other. In our view, the closest one can see is a correlation between outperforming and missing expectations, as usual, but to an extent that clearly exceeds deviations from expectations. Low valuations, of which the price list is still teeming with, were helpful and positively performance-enhancing.

Despite difficult conditions: Stocks recorded price gains

In view of the economic downturn, which will continue beyond the first half of the year, it is surprising at first glance that stable equities did not outperform the broad market. Two factors are likely to have been the main contributors to this: On the one hand, the high valuations in this group of stocks, and on the other hand, the continued stagnation of interest rates - despite the economic weakness - at an increased level. These remain high compared to the past decade, and during this period, as is well known, the valuations of stable and qualitatively above-average companies have been driven to unknown heights by interest rates. Historically, however, and especially given inflation rates, long-term interest rates are at fairly normal levels.

Looking ahead, the same cannot be said for current inflation rates. These are still clearly too high to be acceptable, and this then also entails comparatively high short-term interest rates as well as a massive inverse interest rate structure, the reliable forerunner of a recession.

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How to deal with the situation? Take cover in anticipation of the recession, take advantage of the short-term high interest rates, buy stable stocks? We still don't believe that's the case.

The cause of inflation this time is the shortage of supplies due to the Ukraine war as well as the pandemic, but also due to government transfers, which often went far beyond what was necessary (afterwards, you always know better). This was garnished with an extremely expansive monetary policy. At the same time, companies and private individuals built up inventories for security purposes that far exceeded their respective needs. All this is currently being brought back to a normal level: Transfers are being ended, money is still demand-creating but to a diminishing extent, the supply side has rearranged itself so that prices have been significantly reduced again, and the central bank has become restrictive.

Recession has been underway for quarters, in small steps

As we see it, we are experiencing a rolling recession: Some industries are seeing their customers not only reduce inventories, which were previously too high, but at the same time adjust to a weakening of final demand. First and foremost, this affects basic industries such as chemicals, which has been in recession for almost a year. Everything that was doable during the pandemic, such as housing renovation, is now returning to normal. In contrast, industries that were not in demand or not able to deliver during Corona are experiencing very solid demand, such as those for many types of services, but also (still) the auto industry. In these industries, the catch-up effect should run its course over the next few months, while companies that have already gone through this normalization as well as the anticipation of a recession should stabilize again.

At the same time, inflation rates should fall significantly as long as the central banks remain restrictive, which they are in our view. The inflation triggers have already seen prices fall significantly again. The high inflation rates that are visible today stem from catch-up effects, e.g. in wages, or precisely from price increases that are due to the explosion in basic material prices but are not attributed to them. Vegetable prices are a good example here, after the cultivation of vegetables in greenhouses was often no longer worthwhile in view of the extremely high gas prices. This is now likely to change again, and so is much of what is attributed to the core inflation rate.

All in all, a very solid nominal headwind, but stretched over a longer period, with unemployment remaining very low. To begin with, this is a lagging trend. However, the scarcity of labor meant that a lot of things were not implemented, which may now be catching up. Perhaps even craftsmen are once again available.

The cautious sentiment reduces the risks

In our view, this means the following for the stock market: First, everyone has been talking about the recession for quarters. Consequently, it will not strike out of the blue. Since companies, but also most investors, have been thinking along these lines, the most unpleasant effects, such as overproduction that has to be sold at large discounts, overcapacities that have to be reduced slowly and cost a lot of money via

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restructuring measures, but also the stress on the financing side, are likely to be more manageable than was the case in the past. It should be added, however, that the situation in China appears to be very opaque and this could possibly be the biggest problem. However, perhaps not.

In this respect, the recession is probably largely priced in, even if short-term volatility can never be ruled out. Investors are cautiously positioned. The bond market is still valued in such a way that making money in real terms is virtually impossible, as has been the case over the past ten years. On the stock market, on the other hand, inflation is conveniently compensated for in the form of nominal growth, since the latter is higher than in times of low inflation thanks to higher inflation. Incidentally, this correlation is practically never taken into account when comparing the earnings yields of stocks and the interest rates of bonds: it would be smarter to use the real interest rates of bonds as a yardstick. As far as stock earnings estimates are concerned, they have certainly not yet taken the worst-case scenario into account. However, even a halfway normal profit situation for many companies has certainly not been priced in.

Generally speaking, price drivers are always aspects that have not yet been taken into account because they were not known. "Black swans" are the best example of this. On the stock market, the negative surprise potentials are slowly running out, unless you have a blooming imagination. With the pandemic, the war in Europe, the diplomatic tensions with China and many other countries, and last but not least the climate crisis, there are many things on the negative side that the market should have taken into account by now, especially since they are no longer "new news". As a result, the valuation of many companies is at a low level that has seldom been reached outside of crisis situations (which then also come as a surprise). This does not apply to all companies, and the yardstick is not always profit, but occasionally also the substance of a company. All in all, however, we see the German stock market as quite promising, especially in comparison with other asset classes, also and especially in view of the creeping recession.

Stable stock markets indicate low valuations in view of the economic environment

It should also be borne in mind that even away from the big political stage, the underlying conditions over the past 18 months have been anything but easy. The fact that the economy is weakening and is more or less in recession is one aspect. At the same time, a debacle took place on the bond markets that almost led to a banking crisis in the U.S. and wiped out the profits, including interest, from the last ten years. In the real estate markets and also in the private equity and venture capital markets, which were previously still regarded as safe havens, the impacts are accumulating, and financing is increasingly on the brink of collapse. In normal times, this would have led market observers to expect that the stock market would at least not necessarily be near its record high. Nor does it, if the development is based solely on share prices excluding dividend payments, at least in Germany. But what can be said about the market: It is very stable, measured against historical experience, and volatility is at a very low level. This speaks for the resilience of the

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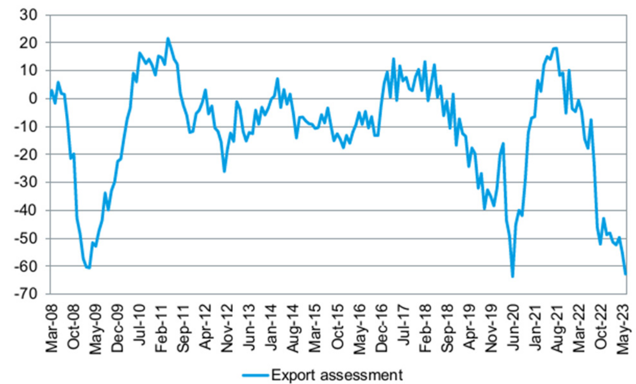
price level, which in turn is based on a low valuation.

Various aspects prove the attractiveness of equities

Another indication of the attractiveness of share prices is the fact that share buybacks by companies have increased sharply. Not so long ago, share buybacks in Germany were (wrongly) seen as evidence of corporate failure. Today, among the DAX companies conducting buybacks are: Allianz, BMW, Commerzbank, Daimler Truck (coming soon), Deutsche Bank, Deutsche Börse, Deutsche Telekom (through its US subsidiary), Heidelberg Materials, Mercedes, Munich Re. The situation is similar in the indices ranking below the DAX. This should not only underpin the attractiveness of the valuation, but is also one of the best approaches to create value for shareholders. This will not be elaborated here for reasons of space, but it has been proven many times and is a mathematical triviality as long as the valuation of a company is not clearly too expensive.

As an individual example, here is a simple presentation of the situation with the help of three charts concerning BASF and the chemical industry. Lows in every respect. And the basis on which substantial price gains were made in the past. Disclaimer: We do not own BASF shares, but this is something that can change quickly.

ifo sentiment export indicator for the chemical industry



Source: ifo, Refinitiv, Baader Helvea Equity Research

And as can be seen: Despite the lows in the ifo indicator, there were no new lows in BASF's share price and valuation, measured by book value. Which could mean that the bad news had been more or less factored into the share prices.

Finally, what is possible on the stock market will be shown by looking at the valuation of real estate. While in the "real" world real estate trades at a discount to peak prices of perhaps 10-15%, real estate stocks have crashed 60-80%, sometimes even more. Leaving out the

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cases where a company has gone bust, taking into account corporate debt, this means that valuations have fallen by 30-35%. This is not because the shares were absurdly overvalued before, quite the opposite: today, as one or two years ago, the valuations of listed real estate companies are far below the reconstruction costs of the properties, taking into account depreciation. If one converts the valuation of the properties to the square meter, the discounts of the "listed" properties compared to the prices paid for the properties themselves are 25% and more. What is the reason for this difference? The yardstick for the valuation of non-"listed" real estate, i.e. primarily real estate held by private individuals, cooperatives and the public sector, is interest rates. The yardstick for the more or less identical properties owned by listed stock companies is the valuations of other listed companies. And these are valued much lower than bonds, or to put it another way: The yields of their shares are considerably higher than those of bonds. Once again, the discrepancy in the valuations of shares and bonds becomes clear.

All in all, it remains the case that for those who are not tied to their investments for regulatory reasons or due to short-term payment obligations, equity investments should continue to be the top priority.

Sincerely yours,

Martin Wirth

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