FPM-Comment Reducing the Noise

Martin Wirth – 4/2021 dated October 11th 2021

Turning point on the financial markets?!

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- Price increases and supply chain issues
- Where are energy prices heading
- Expectations from central banks
- Impact on the stock market

Stock market consolidates in the third quarter

1 In the third quarter, the German stock market consolidated the gains of the previous quarters and recorded a slight price decline at index level. This went hand in hand with a slowdown in economic momentum, which on the one hand was base-related due to the weak prior-year period, but on the other hand was reinforced by two trends that only a short time ago few market participants had expected to occur in this way: Significant and more sustained than expected price increases and a shortage of materials of all kinds, which additionally fueled the rates of price increases.

The correction from the interim highs was much stronger at the level of individual stocks than the index movement reflects. 10% was more the lower limit of the correction. In the case of stocks whose business was affected by the increasingly difficult operating environment, the price declines were also significantly higher. As the correction was on a rolling basis, this was not reflected by the index. This shows once again what diversification is good for.

Two new share price spoilers: price increases and problems in the supply chains

These two spoilers are likely to be with us for a while, and understanding and classifying them correctly should have a significant impact on the performance of the selected stocks; in addition, of course, to the individual parameters of the individual companies.

First of all, the shortage of materials: this has been going on for months across all industries, but subsequently also affects many service companies. It is not just semiconductors, chemicals or energy raw materials. One gets the impression that almost everywhere, something is not running smoothly. This is reflected in prices, but sometimes also simply in companies' inability to deliver. Companies are affected in different ways: There are clear winners, namely many of the producers close to raw materials. For some

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companies, the situation is ambivalent: lower volumes are offset by a significant increase in pricing power, as is the case for the auto industry, for example. This is bad for companies that either cannot pass on prices to customers or are simply hit by secondary effects, such as auto suppliers: Even if the individual companies could deliver, products are increasingly not called off because parts from other suppliers are not available and therefore the planned quantities cannot be produced. Missing contribution margins are not compensated by higher prices: This depresses profits, in some cases significantly.

Supply chain problem will clear up as Corona infections decline

The intriguing question now is: where do these problems come from, and how long will they last? Two causes are conceivable: Fundamental shortages in individual areas, or corona-related distortions in the supply chain. With exceptions such as probably/possibly the semiconductor or energy industries, we believe most dislocations are temporary. Value chains today are extremely long, often small-scale and global. The failure of a company or a logistics provider, e.g. due to a lockdown, leads to a chain reaction that can have global effects. This could be seen in the spring of 2021, when there was a global shortage of timber because fewer trees had been felled a year earlier during the first hard and global lockdown. This has since calmed down significantly. Accordingly, we are also confident that the current problems will be resolved in the coming months. The decisive factor will be how quickly Asia in particular can free itself from the distortions, i.e. achieve a higher vaccination rate. For some possibly real shortages, such as those in the semiconductor industry, we see the usual capitalist solution: if it is profitable, more capacity will be created, it just takes a little longer. But the most important thing is: Fixing the logistic problems will lead to a much easier planning, and if then a few semiconductors are missing, this is not the very big problem.

Open question: Where do energy prices tend to go?

The situation could be different with the shortage in the energy sector, for non-capitalistic reasons, namely - in short - ESG-related. For years, investments have been cut back here, partly because there is no more financing for them, and perhaps also because they are no longer profitable in the long term. In the short term, however, demand is more or less set, and is even increasing globally. Even if no one wants to hear it so much: this problem could be more sustainable. At least, the possibility should be kept in mind. This would have three consequences: Production of some goods would be curtailed, inflation rates would rise, and the shift toward renewable energy will be faster than without these developments. The good news is that globally, the share of energy bills in total national income is much lower than it was in, say, the 1970s.

In sum, regarding the current material shortage aspect: we believe that buying opportunities will arise in the more cyclical sectors in the coming weeks. If there is a recession or significant slowdown in the economy, it will be supply driven and not demand driven for the first time in very many years. Exception: 2020 by Corona. Consequently, demand will not be the bottleneck, which should keep the economy on a very solid path in 2022.

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The drivers of falling inflation rates are starting to turn around

Turning to the second topic, inflation rates. The combination of supply-side cooling with scarcity-driven price increases has already led some market observers to talk of stagflation, one of the worst environments for equity investment. Formally correct, but probably not sustainable. On the economic side, we expect the situation to ease, as described above, and inflation rates are unlikely to remain at current levels for long. However, we do not expect to see the old levels, which are obviously still the basis for valuations on the financial markets, any time soon either. Apart from the current corona-related disruptions, many of the trends that led to the low inflation rates are no longer to be expected in the future: labor shortages, outsourcing to low-wage countries that has reached its limits, value chains that can no longer withstand greater stresses, fair-weather strategies in the procurement of raw materials, and, above all, the costs that the measures to combat climate change will generate. Add to this the equally obvious turn of the times in the assessment of government deficits: Sound fiscal management is no longer seen as the source of prosperity. Instead, the assumption is that the additional debt that more and more states are willing to take on will be invested highly efficiently in a variety of projects. Our expectations are definitely dampened after 18 months of Corona policy. Nevertheless, we cannot negate these facts. What will continue to dampen inflation are digitization and automation, both of which are no longer entirely new developments, however, and which would have to significantly outstrip previous productivity increases once again in order to bring about a development in price increases comparable with recent years. This is anything but certain. In a nutshell, we believe that we are on the verge of a turnaround, and we should be prepared for this. Anyone who does not want to believe that such a thing is possible can look at the development of prices for non-tradable goods and services and will see that for years we have had inflation well above the zero line, depressed only by the trends described above, but even then approaching zero only in exceptional cases. Which in Germany for 20 years still led to an inflation rate of 1.5%.

Central banks will react cautiously to rising inflation rates

The central banks have already announced how they will behave in such a changed environment: Very cautiously. First of all, if this is indeed the price turnaround, it will take longer for it to be recognized as such by the central banks. In this respect, it should not be assumed that interest rates will reflect current inflation rates in the near future, and thus further real losses for investors in the fixed-interest area are to be expected.

Impact on the stock market

So what does all this mean for the stock market?

With regard to the first question (availability of supplier products), we now see more opportunities than risks, after various shares have recorded significant price losses, precisely because of what we see as unsustainable distortions. Experience has shown that many issues that appear in the newspapers have already been priced in by the stock market. In general, under these conditions, it makes sense to be invested in companies that can pass on cost increases to their customers and

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are not prevented from doing so by laws or contracts. Fortunately, the group of companies to which this applies tends to be the more favorable in the stock market anyway.

Old favorites no longer outperform, but show vulnerability

More important, however, is the question of the level of inflation and the central banks' reaction to it. In our view, there is no point in making a bet on the level of inflation. Instead, one should get an idea of what is priced into the markets and whether this is realistic. In our view, despite some shifts, it is still the case that equity markets are betting on a continuation of the environment of the last decade or more. And as described, from today's perspective, we consider this to be almost an extreme scenario, which is not impossible, but not the most likely. However, it has to be said that even more than the markets, many commentators expect this continuation: because for a year now, at least on the German stock market, it has no longer been possible to outperform with the "growth" and "high quality" strategy, quite generally speaking. More and more stocks are coming under pressure, unless they achieve exorbitant growth rates that exceed high expectations. Quite difficult are shares of companies that disappoint profit expectations. Here, more and more shares of former high-flyers are in established downtrends.

At the end of the day, the justification of value investing is apparent: It doesn't mean that every stock will perform great. Sometimes it is also sufficient to simply not lose money, even if you are not right with your assessment. If the value doesn't matter at all, but only the great story combined with an exorbitant valuation, then at some point you can expect substantial losses should your expectations be disappointed - even for a manageable period of time. It is often a long way before value investors then get on board. It is better not to rely on the purchases of friends of hot stories.

Stock market starts to price in rising inflation rates

Perhaps one should also consider the following: the fact that the central bank is setting interest rates low at the short end and pushing them down at the long end by buying government bonds should not lull an investor into a sense of security. Since the central bank (at least the ECB) is not yet buying stocks directly, you can't rely on a buyer here. And perhaps it is the case that the "swarm intelligence" of the stock market is simply starting to price in higher interest rates here, which we would also have in the interest rate markets without central bank intervention. Looking at the price performance of a growing number of stocks, one can get that impression. Not much has happened yet: The valuation differences between the darlings of recent years and the rest of the stock market remain at an extremely high level.

Better not rely on the central banks: The unintended redistribution is gigantic...

Another aspect that should make an investor curb his expectations of central bank policy is the unintended consequences of central bank policy: It redistributes wealth from creditors to debtors in a way that is not in line with the market, from owners of interest-bearing securities to owners of real assets: First and foremost, these are real estate and certain stocks. This subsidization of real

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estate ownership in turn reduces the supply of real estate, which then drives up rents and prices. Due to the great economic importance of real estate, this effect is known to be unmistakable. This should also apply to the ECB, which in turn is likely to view these effects as anything but welcome. Since private assets as well as private debt are significantly larger than government debt, the undesirable side effects are now greater than the intended ones. Thus, in our view, the ECB is caught in a trap: It cannot manipulate interest rates downward in favor of the sovereigns without accepting the distributional impact in the private sector. The complaints of bank customers about "penalty interest rates" for which the commercial banks are not responsible are just the tip of the iceberg. Apparently, the drop in interest rates from 1% to 0% is less painful than from 0% to -0.25%. Thus, the ECB will actually have to react in the foreseeable future if it does not want to continue this game. Just to illustrate the dimension: with financial assets of €5 trillion in Germany alone, an interest rate differential of one percent is worth €50 billion. A redistribution free of any political legitimacy constraint: That was not the plan.

... and sovereign bankruptcies due to gradually rising interest rates are an unrealistic threat

For many observers, only one problem remains: namely, that many states, thanks to their high debt levels, would not be able to withstand even a slight rise in interest rates. However, we consider it lazy thinking to see this as inevitable: governments benefit from inflation through rising tax revenues, a real decline in government debt and, initially, from the interest rates on their outstanding government bonds, which are often fixed for years. Moreover, gradually rising interest rates do not disappear into nowhere, but end up with savers. In this respect, the distribution of income is the only issue at stake in the end. But it is also true that if governments do not take any measures to adjust to rising interest rates in the long term, they will have a problem at some point. On the basis of the last ten years, we should temper our positive expectations. But there is nothing compelling here. In this respect, this cannot be the dominant criterion of central bank policy. And thus, one should not be under the illusion that this is the reason why nothing will change.

Stock market: Solid overall, with areas to avoid

In summary, the situation from our point of view is as follows:

Interest rates should rise, and the pressure on central banks will increase.

This is only reflected to a small extent in the stock market. The valuation discrepancies between the individual sectors are still far too large.

The vast majority of stocks are fairly valued, and some are low. The darlings of recent years are expensive: stocks with a quality well above average, with a very stable business and in some cases companies with growth rates well above average.

The group of expensive stocks is showing signs of fatigue, while the other stocks tend to trend positively on balance.

Compared with interest rates, most equities are valued low. However, this is no protection, especially for stocks with a long duration, should interest rates rise. For the rest of the market, the question is what the course of the rise will be should interest rates rise. From today's perspective, we are relying on the management

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skills of the central banks, so we do not expect a chaotic course.

Sincerely yours,

Martin Wirth

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