FPM-Comment Reducing the Noise

Raik Hoffmann – 1/2019 dated June 5th 2019

Greater clarity would be desirable – but our portfolios have historically high intrinsic value

Raik Hoffmann – Fund Manager and Member of the Board FPM AG

- Experience in German equities since 1997
- Funds: mutual funds FPM Funds Stockpicker Germany Small/Mid Cap, FPM Funds Ladon – European Value, special mandate for Sycomore Asset Management, Paris

- Continued massive divergence between value and quality/growth
- Heidelberger Druckmaschinen highlights doubts about the efficiency of the capital markets
- Our consistent style should not be confused with obstinacy

Lights are not yet green

In our outlook for this year, we predicted that the economic development would be relatively subdued until the summer due to the ongoing weakness of manufacturing industry, which is so important for Germany, and forecast that this would be followed by a return to trend growth in the second half of the year. Consequently, we had expected to be able to give the “green light” in this update. For that, it would have been helpful if our assumptions had been borne out by greater clarity in the trade disputes and an improvement in the leading indicators. Until recently, it seemed that the trade issue was “presumably over”, the situation now looks more like a power struggle between two major rivals. That is a less favourable scenario, which we mentioned in our FPM outlook for the year, but had hoped would not materialise. The leading global indicators are not yet pointing to a trend reversal. More on that later.

Quality/growth is more popular than value investment at present

Looking solely at index levels suggests that the markets have switched from “red” to “green”, but closer inspection reveals a somewhat different picture. Driven by the interest rate turnaround, especially by the Fed in the USA, the equity markets were able to rise significantly until recently. That said, a comparison of investment styles shows that the quality and growth styles (and preferably a combination of the two) have once again performed far better than value investment. While rising interest rates put increasing pressure on equities in the second half of 2018, the reversal of central bank policy has revived the old "animal spirit". Low interest rates justify higher valuations. However, since growth prospects remain uncertain, people see buying quality/growth stocks as the best option. Although most valuations here are high to extremely high, some investors still consider them to be cheap compared with ten-year government bonds.

Heidelberger Druckmaschinen: are the capital markets really efficient?

Although some shares in our portfolios have dropped back since the start of the year, correcting the most exaggerated previous rises, by and large the portfolios still do not contain any goodwill and some shares continued to lose value. One example is Heidelberger Druckmaschinen AG, which met the targets it set. Nevertheless, the share price dropped sharply again in the wake of flat year-on-year sales and earnings guidance and a shift in the mid-term targets as a result of the global uncertainty. At present, the share is almost back where it was in 2012 when the company was making a big loss and was on the brink of insolvency, forcing massive restructuring with an uncertain outcome. The market does not seem to be interested in the fact that Heidelberger Druck has now been restructured, is far more profitable and with a better balance sheet, nor that further cost-savings are on the cards in the coming years and the new subscription model has shifted revenue and earnings into the future. The share has fallen by more than 60% since summer 2018. It is said that the market is always right, yet this raises doubts about the assumed efficiency of the capital markets. This example highlights the challenge we are currently facing as a value investor. In some cases, business models that are (presumed to be) stable and risk-free result in exorbitant valuations, which we are not willing to pay for. Quite simply, because – analogously to government bonds – these shares would only make sensible investments in a few extreme scenarios. On the other hand, there are many companies with very low valuations whose only blemish is that it is somewhat more difficult to predict how they will develop in the coming years. Not that we cannot apply a valuation structure to them. However, an accurate forecast for this year or next is not possible. That said, value investors and stock pickers are rewarded with such high discounts that for anyone with a longer investment horizon the conditions are heavenly. Regrettably, the often short-term capital market perspective can temporarily result in relative underperformance, which is currently testing the patience of our investors. To exclude such relative underperformance, we too would have to buy shares that we consider to be overpriced in the hope that they will continue to outperform for a while — maybe a week, a month or a year, who knows. Ultimately, that would mean speculating on the continued outperformance of overpriced shares – which is exactly the opposite of investing. Investing in inexpensive companies in the expectation that the price will move back into line with their fair value at some time is the better long-term investment strategy in our view. Although sticking to our investment style may seem obstinate at present, remaining uncompromisingly true to our value approach and valuation framework has repeatedly yielded very good results for our investors..

Valuation spreads present an opportunity

As we explained in our last update, the financial markets repeatedly "return to the mean". Valuation spreads, especially extreme spreads, never last but evidently it is only possible to ascertain when they end with hindsight. Probably, a slight rise in interest rates (or at any rate no

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

negative rates on ten-year government bonds) and a slight improvement in the inflation environment or inflation expectations would be necessary for that. However, the valuation spreads are now so enormous that the opportunity/risk profile of our investment style is becoming increasingly attractive. Even the absence of deflation should be sufficient to support value stocks. Time will tell whether that is sufficient in the short term in the present climate of uncertainty.

Trade dispute scenarios

Unfortunately, it has become fairly clear in the past few weeks that the "trade conflict" is likely to stay with us for some time. In the surprising event that a solution is found, it is more likely to be a temporary ceasefire than a long-term outcome. This assessment is based less on the latest increase in customs duties than on the escalation of the Huawei situation. Now, if not before, it has become evident that (geo)political and strategic considerations rather than trade deficits are the heart of the matter. As a result of this step, Silicon Valley & Co. will lose billions in revenue, perhaps not immediately as an agreement is still possible, but very likely in the medium term. China will endeavour to become independent of US technology even sooner. The plans to build up its own semiconductor industry, with generous subsidies as usual, are nothing new and will doubtless be stepped up further, regardless whether some sort of "agreement" is reached. Trump's willingness to accept this risk shows the (new?) dimension of this dispute. At the same time, it reduces the real willingness of both sides to reach agreement. For many years, China has been endeavouring to secure unilateral advantages (subsidising/protecting industries and state-owned firms to create global champions, geostrategic expansion into resource-rich countries, building up islands in foreign territory, ...) and is more likely to press ahead with this than to halt it, while it seems that the USA is no longer prepared to tolerate it. Whether the present high valuations of technology stocks are still appropriate is a question that should at least be considered. Quite possibly it will be the trigger that ends the absolute market focus on quality/growth stocks.

The market has priced in the fact that Europe can only be the loser in this situation. If there is no solution, the global uncertainty will affect Europe more than the USA, because Europe is more dependent on exports. If there is some sort of a "solution", Trump's next step will be to impose customs duties on European cars. At the same time, Europe will increasingly come under pressure to side with one party – which is unlikely to be an easy task given the differences of opinion within Europe. That is compounded by the fact that for years the German government has been passing laws that reduce rather than improve Germany's competitiveness.

In our view, the trade war is unlikely to result in a recession. But precisely that is already priced into some market segments. Uncertainty is deadly for economic momentum. Psychology plays a big part in the economy, so investment decisions are being put off as a result of the present uncertainty. If it is not clear, for example, whether customs duties will be imposed on cars traded between the USA and Europe, non-urgent investment will be postponed. The same goes for Brexit. While Brexit is not in itself a catastrophe (because ultimately the exchange rate will see to that), until the future conditions are clear, visual flight mode is the order of the day. And Chinese consumers, who are already known for a certain collective herd mentality, are continuing to refrain from buying cars (especially Chinese

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

cars), and that is is affecting German automotive suppliers more than German car producers. Even the reduction in value-added tax did not reverse the trend in April and May. That is the feedback we get from talking to companies.

The uncertainty is also reflected in the purchasing managers' indices and the Ifo index. Following a brief uptrend in March, the latest data have dropped back again. In the USA, there is a rapid downward trend: the latest purchasing managers' index for manufacturing industry has dropped to the 2009 (!) level. A certain reduction was to be expected since the impact of the 2018 tax reform and stimulus programme is coming to an end (annual reference base). So far, the weakness is confined to manufacturing industry, while the service sector has remained robust – as it has in Germany. Therefore it is highly likely that growth will be below the trend, unless an unexpected "agreement" is reached in the trade dispute. However, that would also mean that monetary policy would remain extremely easy, justifying higher stock market valuations as long as there is not a strong recession that puts significant pressure on profits. As already mentioned, however, a recession is not part of our base scenario because, except in China, there are insufficient signs of key preconditions for that, e.g. mispricing, bubbles and misguided investments. It therefore seems possible that ten-year German government bonds could at least move out of negative into slightly positive territory. Given normal growth, that would be more than justified from a fundamental viewpoint and would not damage the equity markets as a whole, although it would probably be slightly positive for our shares.

Rising or at least stable inflation expectations?

That leaves the question of inflation, which the market seems to have more or less permanently laid to rest. After 40 years of declining and zero interest rates, rising inflation rates seem to be inconceivable. The ageing population in western industrialised countries, globalisation, new technologies and greater price transparency as a result of the internet are some of the reasons for this. On the other hand, higher inflation rates are not strictly necessary. Including rents and home ownership on a comparable basis, inflation in Europe is also around 1.5 to 2 % as it currently is in the USA, and those are not numbers that would justify negative interest rates. If we ask ourselves what could happen on the capital market that the vast majority of people are not expecting, it could be precisely that. Alongside the arguments in favour of sustained low inflation and interest rates outlined above, there are also some counter-arguments. Nothing that could bring a massive change of direction in the next 6 to 12 months, but equally, arguments that should not be completely ignored on a long-term view. As we have said, an end of the deflation debate would be enough to raise capital market rates.

So what are the arguments in favour of rising or at least stable inflationary expectations? Even if the introduction of customs duties represents a shift in prices, together with the shift in production and value chains away from low-wage countries, it would naturally have an inflationary effect. The reversal of globalisation is due partly to rapidly rising wages in these countries. For example, there are increasing labour shortages in Eastern Europe. As a result, wage increases are now in the clear double-digit percentage range. Virtually full employment in Germany and many other industrialised countries will also tend to drive inflation. This will be exacerbated by the fact

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de

that the baby boom generation will be retiring in the next few years. At the same time, redistribution of income will increasingly be a response to right-wing populists. All in all, the situation is likely to increase purchasing power and thus the inflationary trend.

Thinking through climate change to its logical conclusion, even if it will only be tackled half-heartedly for as long as possible because it is such a big challenge, rising costs are the only logical consequence. However, following the elections to the EU parliament, it is increasingly doubtful whether the established parties' half-hearted wait-and-see approach will continue to work. Production resources are becoming obsolete (examples are phasing out coal, but also all other energy-intensive sectors). Therefore, massive investment is needed in new energy sources, infrastructure, etc. And that will not happen for free. Poorer quality soil, crop failures as a result of more extreme weather conditions, rising scepticism about industrial farming accompanied by population growth and rising affluence (meat consumption) also suggest that food prices are unlikely to remain stable. 40 years of declining inflation rates have become firmly entrenched in inflation expectations and it will be some time before they start to rise again. But that is not entirely impossible in our view.

Is the present uncertainty a good entry point?

Overall, the picture is somewhat mixed but there is potential for good returns on the equity market. Perhaps the situation is not as clear as might be desirable at this point in time, partly because the guidance issued by some companies assumes a recovery in the second half of the year, although there are not yet any signs of this. That could result in further downward profit revisions in the coming weeks. Nevertheless, at the moment it is not difficult for stock pickers to put together a portfolio of extremely cheap shares with valuations that would only drop in the event of a major crisis. Minor setbacks cannot be ruled out in the short term as the market recovery in the first quarter ran ahead of the leading indicators. In view of the interest rate level and present valuations, however, this should not be excessive. As an average for our portfolios, we see upside potential of around 90% of their intrinsic value. Historically, that is at the upper end of expectations. In line with this, the present uncertainty could prove a good point to buy into our funds.

Sincerely yours,

Raik Hoffmann

FPM Frankfurt Performance Management AG • Freiherr-vom-Stein-Str. 11• D-60323 Frankfurt am Main
Telephone: +49 69.795886-0 • E-mail: kontakt@fpm-ag.de • Website: www.fpm-ag.de