FPM-Comment Reducing the Noise

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The night is darkest just before dawn

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- Are the business expectations of German companies too pessimistic?
- How likely is a recession in the USA?
- Has the manufacturing sector bottomed out or deteriorated further?
- Does the short-term outperformance of value stocks over growth stocks continue?
- Is inflation really dead?
- Opportunities and risks for the remainder of 2019?

If current media sentiment is to be believed, a recession in the USA in 2020 is more or less certain. Just look at the inverted yield curve. There is a strong probability that Germany is already in a technical recession (two consecutive quarters with negative GDP growth). Trade war, Brexit, the protests in Hong Kong, an oil price shock as a result of a war in the Middle East, tension on the money market reminiscent of the height of the financial crisis, the ECB in panic mode and the prospect that Donald Trump's successor could be socialist Elizabeth Warren. The list could be extended: doom and gloom wherever we look. But as Christmas goodies start to appear on the supermarket shelves, we would like to light the first candle to shed some light in the darkness. When the sun actually rises, the best moments could already be over.

Is a recession really inevitable?

While the German economy has been in downward mode since the start of 2018,

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the US economy held firm for a long time, supported by tax cuts and far lower dependence on foreign trade. While the USA has been deregulating (although not everything is to be welcomed), Germany has been doing the opposite. The German automotive industry, which is probably the envy of every country in the world, is being systematically undermined by "professional politicians", who seem determined to bring about its demise. "I'll be honest with you: Frankfurt needs more buses and trains, not more SUVs." That is a quote from the speech prepared by the mayor of Frankfurt – who is also Chairman of the Supervisory Board of the Frankfurt exhibition centre – for this year's IAA motor show in the city. Until then, I had thought that increasing the number of buses and trains was a job for the city's mayor, as Chairman of the Supervisory Board of the regional public transport network, and did not really have anything to do with BMW, Daimler & co. You learn something new every day!

Few people would deny that the tax rate in Germany has risen since Angela Merkel became Chancellor in 2005 and that a genuine reduction in progressive taxation is overdue (does anyone in a (West) German city really consider themselves to be a top earner on a salary of EUR 56,000?). Since Germany has been resting on its laurels for 15 years and almost all political action in the recent years has brought a deterioration in business conditions, we are still massively dependent on the mood and volatility of foreign trade, with the ongoing uncertainty caused by the trade war and Brexit leading to a wait-and-see mentality. Investment is being put off, inventories reduced, and the focus is on generating cash flow. If everyone does that at the same time – and it is fairly clear that budgets were reviewed at the half-year stage and companies started to put their foot on the brake – sentiment is at a low point, resulting in a spate of profit warnings. The Ifo index of business expectations is lower than it was in the euro crisis in 2012 and moving towards the level seen in the second half of 2009, which seems excessively pessimistic. The present situation, at any rate, is far less negative.

The drop in sentiment in manufacturing industry can also be observed in other countries, including the USA, although it is less pronounced than in Germany, and there have been signs that it has been bottoming out since the summer. Besides, while manufacturing industry is in recession, consumer spending is holding up well.
That will not necessarily go on for ever, but in the USA, in particular, consumer sentiment seems to be in very good shape (solid savings rate, high growth in incomes). The decline in long-term mortgage rates and interest rate cuts by the Fed will bring a further boost. Therefore, we consider a recession in the USA to be very unlikely. The Citi Economic Surprise Index in the USA turned sharply positive.

Since it also appears that both sides in the trade war are moderating their extremely aggressive rhetoric and mutual concessions

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are being made, more constructive negotiations could be in the offing. One can never be sure about Trump, but as a "businessman", it may be assumed that he has a better understanding than German politicians that he should not push the uncertainty facing companies too far if he does not want to jeopardise his own re-election.

Value hits back – not just a blip?

Consumer spending is stable, manufacturing industry is in recession worldwide but bottoming out after a downturn of nearly two years, accompanied by postponed investments and lower inventories: the way has been paved for an economic turnaround in the coming months. The Baltic Dry Index, a price index for worldwide shipment of bulk goods, which is trading at the highest level since 2011, points to the hoped-for bottoming out, rather than a further deterioration in the short term.

The sharp changes in the market segments fit in with that: value investing has significantly outperformed momentum, a situation previously seldom seen on individual trading days. At the same time, interest rates have risen considerably. This may have been partly technical (investors too strongly positioned in quality growth/momentum/positioned for falling interest rates), but such strong movements often have longer-term significance. In a movement like this, at most hedge funds and quantitative strategies have corrected their positioning. The positioning of most of the market, however, remains long duration.

Unless value significantly underperforms in the present correction phase (so far, everything is fine), there are many reasons to assume that market forces will reverse, most probably as a result of stabilisation of the economy, even if this is difficult to understand intuitively given some very sharp profit warnings at present. However, since it is a well known fact that the stock market trades on the future, the party is often nearly over when better economic data eventually start to become visible. Therefore, we should not allow ourselves to be dominated by the sense of doom and gloom. Following years of upswing, this is the first real opportunity for companies to change existing structures and undertake restructuring without massive resistance from the trade unions. Therefore, some of the scaremongering could turn out to be exaggerated.

Depending on the market, with indices close to all-time highs (e.g. the S&P 500), it could be argued that the market has already played out the upcoming recovery. However, this year's good performance has been driven by the significant drop in interest rates.
Price trends within the indices have been anything but uniform, resulting in a massive divergence between valuations and price trends for quality growth/long duration assets on the one hand, and those stocks where forecasting is less reliable (cyclicals, operating problems, etc.) on the other.

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While shares in the first category are trading on very high valuations and will probably only receive further momentum if interest rates fall further, many shares in the second category are trading close to recession level. In view of the general market sentiment this is probably hardly surprising.

Zero interest rates – for ever and ever?

What suggests that interest rates could fall further? Given real growth of around 1% in the euro zone (despite the recession in Germany) and inflation of between 1% and 1.5%, the answer is: not much. Yields on 10-year bunds should be around 2% rather than the present level of around - 0.6%. Alongside the standard arguments (ageing population in the western industrialised countries, globalisation, new technologies and greater price transparency as a result of the internet, and bond purchases by the ECB), the reasons for this probably include regulatory factors and the low risk tolerance of many investors as a result of zero interest rates. When interest rates were still positive, investing a certain proportion in shares would ensure the return was plus/minus zero even if prices plummeted. When investors have zero risk tolerance, there is little on offer apart from bonds and quality shares that are regarded as completely safe. Unfortunately, they now command fairytale prices.

Looking at the comments made by members of the ECB after the latest interest-rate decision, the likelihood of further significant rate cuts by the ECB is relatively low unless there is a massive economic shock. That the governor of the Bank of France, in particular, has spoken out against bond purchases, is remarkable. As is the fact that the ECB's president Mario Draghi did not hold a vote, even though there was apparently not a big majority in favour. Moreover, Draghi's comment that it will be up to fiscal policy in the future is a clear indication of where things are heading. In view of demographic change, the real burden on social welfare systems is becoming increasingly evident.

The best example is Germany, which has only just managed to balance its budget despite record tax receipts and billions in interest rate savings. Naturally, that means there is once again nothing left to reduce the pressure on workers. It is relatively clear where that will lead in the near future when the baby boomer generation reaches retirement age. About 20 million people are due to retire in the next two decades. Given the present haphazard income distribution policy, deficits are inevitable. If climate change means that decarbonisation of our economies is necessary, we do not need to worry about too much capital due to the increasingly knowledge-based economy (one of the arguments as to why interest rates are so low).

It is naturally a complete illusion to think that this shift in our economies can take place without people facing rising prices. Typical politician-speak. Although we should not underestimate the scope for invention and

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although ten years ago it was inconceivable that solar power could be generated at today's cost per kilowatt hour, parts of our existing infrastructure will become obsolete (conventional power stations, petrol stations, refineries), will have to be upgraded (blast furnaces, cement factories) or will need to be extended (electricity storage facilities, transmission lines, charging infrastructure). Other issues include forest restructuring, crop failures, more floods, etc. If all that is combined with a reduction in the working population, together with full employment in many areas and rising costs for welfare systems as a result of the ageing population, the question is whether inflation really is as dead as a dodo. The coming decade could therefore bring an unexpected rise in inflation rates and thus rising rather than persistently negative interest rates.

The remainder of 2019 could prove very interesting

Following years of underperformance of value stocks, which has been especially dramatic in the past 18 months, the present situation is very interesting. Many shares have dropped by 50% or more and corporate profit expectations are very low. Unless there is a new external shock, there is a good chance that industry and therefore corporate profits could stabilise or even recover.

With the exception of the Chinese automotive market, which has suffered a significant drop in volume following years of growth, the global economy is actually doing quite well. As a result of the trade conflict, many companies have decided to put things on hold and to cut investment spending and inventories. Psychology often plays a big role in economics. Since the ECB fails to understand this and suddenly leaps in to action, the general uncertainty has increased. As industry starts to recover, the fear of deflation should drop out of market pricing and interest rates should normalise to some extent. That would put pressure on long-duration assets and quality growth stocks and favour value stocks. With the seasonally strongest phase of the year on the stock market about to start and investors positioned very one-sidedly in quality/growth, the remainder of the year could prove very interesting.

We are positioned accordingly!

Sincerely yours,

Raik Hoffmann

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