CONCEPT
VERMÖGENSMANAGEMENT

Normalisation of the state of emergency

Mid-year report
Summer 2015

NORMALISATION OF THE STATE OF EMERGENCY

"Copy & Paste" in the IT field is when contents are stored in the memory using the "Copy" command in order to be inserted in another place using the "Paste" command. On the face of it, we could do something similar with our mid-year report and simply copy text from one of our previous reports. For the central banks are still flooding the capital markets with money, keeping interest rates low and allowing companies to increase their margins to historically very high levels. As a consequence, shares remain the main pillar for returns in a mixed portfolio.

Our recommendation remains an overweight in shares, but get ready to put on the brakes.

The basic result of our analysis would thus be prefaced in the usual way, namely the anchor point in terms of the distribution of assets. And in fact we are not expecting any change in the trend of increasing investments in shares worldwide any time soon, for the simple reason that there are precious few alternatives. To identify this as the cause of the previous rise in share prices and at the same time as an argument for future upturns is anything but reassuring, however. After all, we have to realise that the markets have reached a certain height from which the fall may well be a long one and the impact may well be painful. The sentence about the alleged lack of alternatives to shares will be said for the last time – and probably at its loudest – before the trend turns and it becomes clear in retrospect that there was always an alternative: cash or short-term bonds with high credit ratings.
Looking ahead to the second half of the year, although we continue to regard an overweight in shares as appropriate, we are already taking our foot off the gas and getting ready to put on the brakes.

With each bond that comes to maturity, the pressure to change the composition of assets grows.

Manipulated for years and having in the meantime fallen to zero, interest rates are driving asset managers from confident assurances into doubt, for today they are no longer achieving the returns that were promised or even stipulated by law. German legislators, for example, may have regularly followed the trends in market returns over the past few years by reducing the guaranteed interest rate for newly concluded life insurance policies from a starting point of 4% in 2000 to 1.25% most recently. But the returns on 10-year German government bonds that can be achieved on the market today slipped below this level a year ago (figure 1). It is a dilemma in which company pension funds find themselves and in which they are also joined by associations who have to fulfil pension commitments that they cannot earn with interest-bearing instruments on the market. With each bond that becomes due and that has to be rolled over against minimum returns, the difficulties are exacerbated and the pressure increases to change the composition of assets. It is a phenomenon that is not limited to Germany, but that is widespread throughout the world. In order to counter the state of emergency in investments, asset managers around the globe are seeing themselves forced to exploit the full scope of their

Guaranteed interest rate for life insurance policies in Germany vs returns on 10-year government bonds

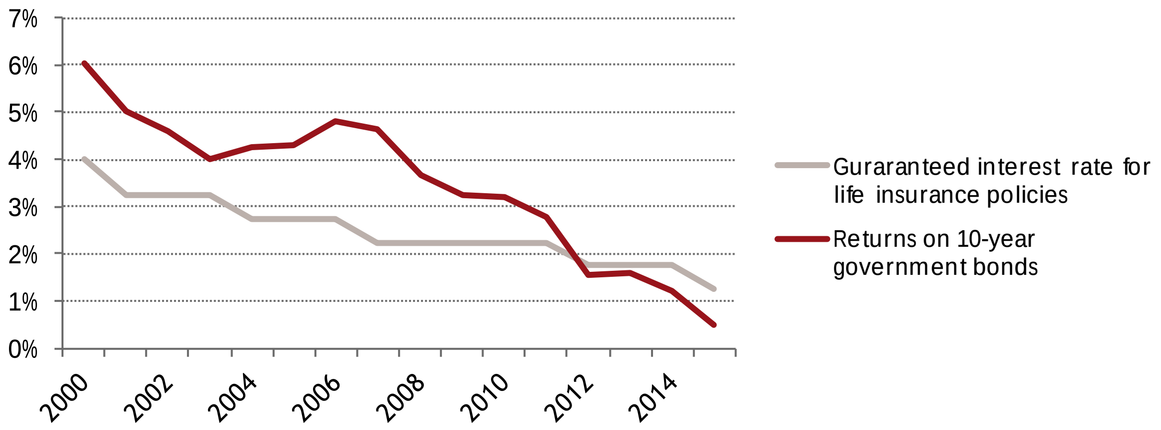

Figure 1 *Source: CONCEPT Research*

investment guidelines and to take on more risk. Our clients are also aware of the discussions surrounding the adjustment of their asset allocation to market circumstances, which are characterised by extreme political manipulation. For the returns on government bonds have fallen by half since the financial crisis broke out in 2007 and have levelled off at all-time lows. And this has happened even though the public debt of the major industrial nations (the US, Germany and Japan) in relation to their national income combined has increased in the meantime by a further 40% from the level at that time. It is a perpetual paradox that can only and - based on our premise - will only be maintained through the permanent supply of central bank money. Currently, USD 127 billion of fresh money is flowing into global markets every month and accelerating the scramble for returns. To come straight to the point: the interest rate hike in the US that has been signalled will come, probably in the later course of the year. It will be done reluctantly and be administered in the smallest dose simply in order to follow up finally on the announcements, long since made, with some kind of action. It is our expectation that the US base rate may well again remain frozen for a long time at the level then reached. The risk of jeopardising the economy, which is performing weakly anyway, and – more importantly – of hitting the national budget in a place that has become very sensitive, namely the interest payments for the high debt level that has been reached, would be too great.

A US interest rate hike should remain marginal.

The economy

A discussion of the general economic data usually forms part of our half-yearly forecast. We do not wish to leave this out, but we will keep it short in favour of market-related considerations that we consider more important and provide it for information purposes only so to speak: the economies worldwide are progressing satisfactorily, slightly weakened in the US because of the strong dollar, somewhat better in Europe and with a focus on the periphery that is now breathing more easily (with the exception of Greece). In Asia, the very high growth rates seem to be declining on account of the saturation effect that is setting in and the dependence on the strong US dollar. Across the world, the

Relatively peaceful economic picture.

No effects of contagion from Greece or China.

low interest rate levels in conjunction with the weak oil price are encouraging economic growth and keeping inflation low; even commodity prices are sticking at a fairly comfortable level. Employment figures are rising in several regions, as are confidence indicators. Greece would basically be a sidebar, if it did not have the potential to call into question the irreversibility of the euro. Whatever happens there, it may well end in personal disaster for many Greeks. For should an "agreement" actually be reached some day as the clock ticks down to the very last minute (the EU summit on 12 July is of course only a first step towards the solution), the economy will choke on the enforced austerity and on its debts. If, on the other hand, Greece goes bankrupt and exits the euro, then ruin would come more swiftly. The country would probably be thrown back within a short time to a small-scale, market-oriented agricultural economy, out of which it would take a long time to grow and then only by means of attractive tourism. A crisis of significantly larger dimensions, on the other hand, is the stock market crash in China, where more than 10 times Greece's annual economic output has evaporated in the form of share price losses in the space of three weeks. Looked at more closely, however, the hysteria merely serves the purposes of the tabloids and is alarming for those punters who only recently jumped credulously on the bandwagon. For the market has simply rowed back on the performance of the last five months and, with gains of a still healthy 8% achieved since the start of the year, settled down in shallower waters among the ranks of its competitors such as the DAX at 10% (share price index), the S&P 500 at minus 0.5% and the Nikkei at plus 13% (as of 11 July 2015).

DRIVING FORCES

All this, however, appears only as a tumultuous (and occasionally distracting) background to a beat that is setting the basic direction and that can be found in the form of the liquidity regularly flowing into the capital markets. It is the main driver for the investment behaviour of the market players on the stock markets (figure 2). Two other important parameters are sufficient

Trend on prominent stock indices against the background of a constant injection of liquidity

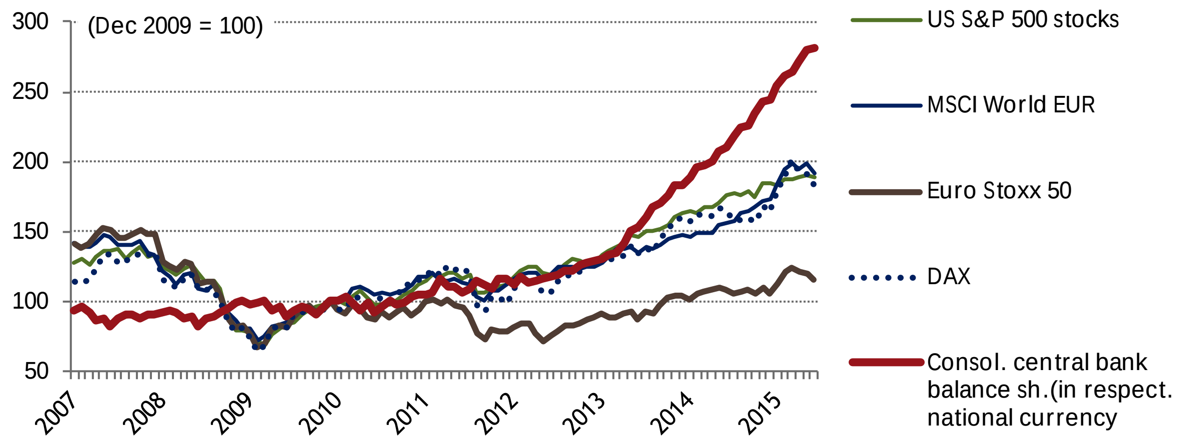

Figure 2 *Source: US Federal Reserve, ECB, Bank of Japan, CONCEPT Research*

Liquidity is the main driver for the investment behaviour of the market players.

– but not strong – economic growth and continued low interest rates. In this environment, shares are inevitably continuing to attract the greatest attention as the investment vehicle with the largest potential returns. They remain strong competition for bonds, which have now also built up notable risk at the level of returns they have achieved. For in the last quarter we came to experience how sensitively the bond market also reacts to changes in expectations when returns are hovering around zero. The realisation that the risks of deflation seem to have been averted and inflationary trends – albeit small – can be seen was sufficient in the present case. Draghi's comment that higher volatility would now also probably have to be expected on the bond market provided exactly for that. At the current level, the bond market apparently opens up more risks than opportunities. Is that one more reason to invest in shares instead? – We believe that an increasing number of market players will actually decide on the risk-on mode, referring to the alleged inevitability. That may allow share prices to continue rising; the mere expectation of this market behaviour is already pushing them higher. What's more, the more positive general data mentioned above seems to legitimise a higher weighting in shares.

WARNING LETTER FROM BASEL

"Move away from the debt-financed growth model that has served as a substitute for structural reforms!"

In its recently published annual report for 2015, the Bank for International Settlements (BIS) has in the meantime[1] come to some very succinct conclusions that give pause for thought. In the light of the low interest rate level that has already persisted for a long time and that correlates only extremely weakly with economic progress, there is reason to doubt whether current monetary policy is appropriate, according to the BIS. The central banks have also probably already had these thoughts. To date, they have not been enough to bring about a volte-face, perhaps because the loss of image associated with the continuation of so far unsuccessful measures is judged to be smaller than might be the case if past mistakes were to be admitted. At any rate, the BIS is recommending moving away from the debt-financed growth model that has served (or outlived) its purpose as a political and social substitute for structural reforms designed to increase productivity. It can be assumed that the political actors know all this. But they also know all about the dependence that has been built up in the meantime by an economic system that is hooked up to cheap money as if it were a drip. For the moment therefore: the risk potential remains unchanged, and too little is being done to reduce it. However, the challenges actually confronting the politicians are being papered over by low financing costs, cheap commodity prices, recovery packages, central bank liquidity and – for Europe – the weak euro and resurgent lending.

[1] BIS: Bank for International Settlements

THE PHYSICS OF THE STOCK MARKET

Measured against classic valuation benchmarks, global stock markets at a price-to-earnings ratio of 16 are not cheap, but they are not expensive either. Adjusting the share indices, which have undoubtedly performed well, by the inflation of the last 15 years, it can even be established that US stocks have only recently returned to the level reached in 2000, even though corporate profits exceed the level at that time by 45% and dividends are even 75% higher (also adjusted for inflation)[2]. In this context, however, it must be taken into consideration that the margins – especially on the pacesetting American market – are swollen by low wage ratios, tax optimisation strategies, favourable refinancing conditions and immense share buybacks. For, on closer inspection, several parameters are definitely also displaying warning signs: market capitalisation in the US has now reached 1.2 times the gross domestic product, a value that has so far been topped only once before at the end of the 1990s (figure 3). The credit volume recorded in the US for purchases of securities has also exceeded a peak value of 3.3% of disposable income not seen since 1959. American shares on the S&P 500 are currently valued at 2.2 times their revenues, also a historical record. Merger and acquisition activities have also reached high levels that were last recorded before the financial crisis. Signs that we now find ourselves at the start of a new bubble can therefore not be shrugged off, and we won't deny them.

Some parameters are sending warning signals.

Valuation of the US stock market as % of gross domestic product

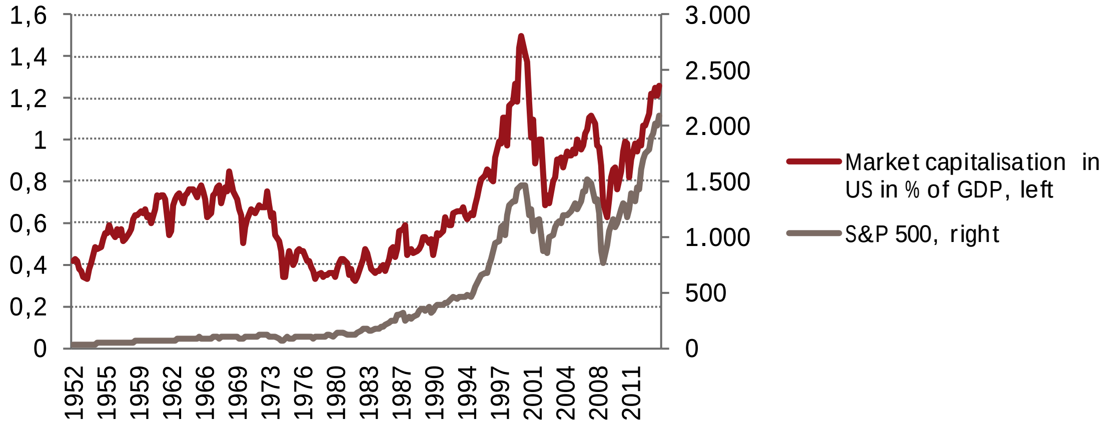

Figure 3 *Source: US Bureau of Economic Analysis, US Federal Reserve, CONCEPT Research*

However: the inherent nature of a bubble is to grow over a long time – sometimes over a surprisingly long time – before the air finally escapes more or less violently at the point of culmination. This can be very well tracked using the Shiller PE ratio[3]. This indicator last reached its current value of 27 for the US in 2007. Today's level has been exceeded only in 1997 and at the end of

[2] Source: LGT Capital

[3] Shiller PE ratio: The price-to-earnings ratio (PE ratio) is usually produced from the relation between the earnings generated by a company over a certain period and the current share price. Share price divided by earnings per share = PE. The Shiller PE ratio follows the approach of smoothing corporate results over at least one economic cycle and then comparing the average earnings of the last 10 years with the current share price.

the 1920s. After 1997, however, shares increased in price for another three years before the maximum of 43 was reached and the trend ended abruptly (figure 4). In physical terms, two parameters play an essential role in bubbles: the pressure of the air flowing in on the one hand and the ambient atmospheric pressure on the other. The two act contrary to each other; the internal pressure expands the bubble, the external pressure

Shiller PE ratio US

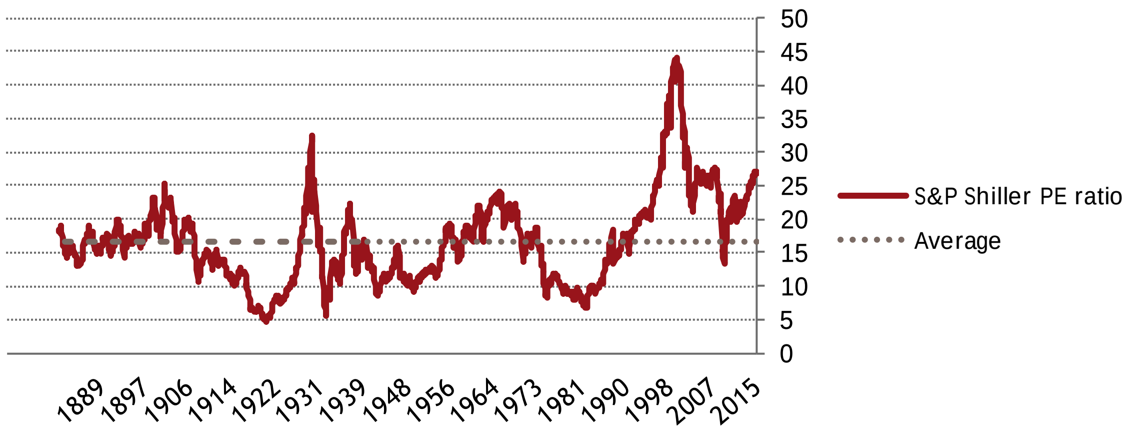

Figure 4 *Source: Multiple.com*

prevents it from inflating until it bursts. In our example, the internal pressure is increased by the ever-growing demand from investors in need of something to invest in, while the ambient atmosphere in the form of constantly and freshly flowing capital represents sufficient compensation in order to prevent an expansion of volume to bursting point. We are assuming that this injection of liquidity – underpinned by the high cash holdings at companies and pension funds on the one hand as well as by the monthly central bank contributions of over USD 120 billion on the other – will continue and drive prices higher. In this respect, there is still no bursting of the bubble as a result of a sudden drop in atmospheric pressure (reduction in liquidity) in sight. Even a decompression through the inlet valve as a result of a possible decline in investor demand cannot currently be inferred. Incidentally, in this analysis the economic trends appear irrelevant to an extent as long as the data does not become "too good", interest rates persist at a low level and liquidity thus remains cheap and readily available.

State of Emergency – The New Normal

Central banks dictate normality: Low interest rates and a constant injection of liquidity.

Historically, interest rate levels have very rarely, at most in times of war, been as low as they are throughout the world at the moment. That lends our bubble extreme powers of resistance. If we earlier pointed to visible warning signs, these can be put into perspective against the background of low to negative interest rates that have become the new normal for the moment. As it is the central banks that are defining this normality, it is extremely forceful. No other market player possesses unlimited liquidity, but the central banks have it in spades. As long as there is the political will to do "whatever it takes", nascent dangers can be squashed with the money press (figure 5). That the independence of the central banks has long been sacrificed and they now bow to the primacy of the political world plays a role here. This is true for the US, for Europe and, in an extreme manifestation, for Japan. What is crucial at this point is that, given the high debt burden, things would become exceptionally precarious for the industrialised countries if interest rates were to rise. Interest payments could very quickly develop into the largest expenditure item – as in Greece. In this respect, we believe that the central

Central bank interest rates US, Japan, EU

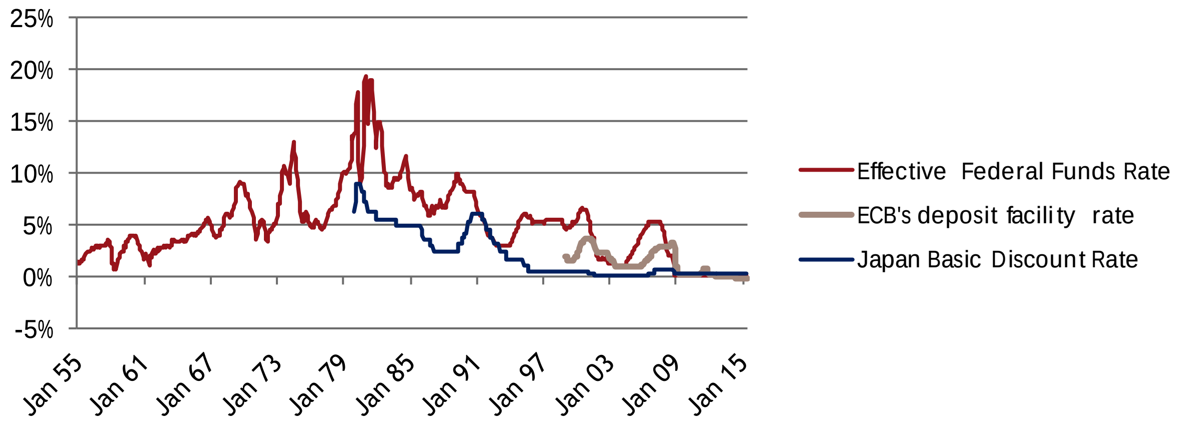

Figure 5 *Source: ECB, Bundesbank, Bank of Japan, CONCEPT Research*
Fed Funds: interest rate between banks in the US, ECB deposit facility rate: Lombard rate eurozone

banks will hold still for a long while before they authorise a hike in interest rates. Leading the way in the concept of financial repression is the tolerance of higher inflation rates in order to reduce debt more swiftly through inflation. This scenario is beginning to take on hazy outlines on the horizon, but we still have some way to go before it becomes reality.

The actual bubble has formed in a totally overvalued bond market.

Are we sitting in a bubble of happiness? Evidently yes, but this analysis is not necessarily reassuring as long as you are a part of the bubble. The increasing volatility – on the stock market and the bond market alike – clearly shows how susceptible the markets have become to the smallest deviations from the perfect scenario, which will nevertheless be replayed immediately when the disruptive factors fade away or even only appear to fade away. The capital markets have reached a certain drop height that would provide leeway for large-scale corrections if an ill wind were to blow in from whatever direction. And this will not be the direction that most people are looking in, where China and Greece have de facto already been eliminated as triggers of the crisis. The actual bubble has formed in a bond market that is totally overvalued because it is politically controlled. Ever since the financial crisis, operations here have been conducted under the protective mechanisms of a state of emergency. It is for that reason that we are closely monitoring the market depth in this segment, which has become significantly shallower and which, in conjunction with the supply shortage resulting from the central bank purchases, is clearly adversely impacting on the capacity to absorb large-scale sales. We are also keeping a critical eye on the trends in inflation, the possible return of which is on the radar of exceedingly few. The base effect of the significant fall in the oil price last year, a trend that is obviously not going to continue in the same way, is on its own providing for greater sensitivity in these indicators. With a rise, the extent of which was last seen at the beginning of 2008, the labour cost index also shows that the US is headed towards quasi full employment and that it may well be difficult to keep wage costs low as in the past. An inflation rate that increases more sharply than assumed to date could allow interest rates to rise unexpectedly sharply and severely test the absorption capacity of the bond market.

For the above reasons, we remain invested, but are moving closer to the exit. In our opinion, the fluctuations on the markets will continue to increase, as will the demands placed on asset management. As a result, we will need to be more flexible and constantly review our own view of the market – including the one formulated here. That will be our challenge in the second half of the year.

Bielefeld, 14 July 2015
Matthias Steinhauer

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