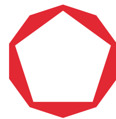
Advertising Material

Capital Market Report 2020

Weird World



Flossbach von Storch

Flossbach von Storch

Capital Market Report 2020

Weird World

Dear Clients and Investors,

The year 2020 was an unusual and equally unsettling one. Covid-19 changed our lives. In addition to threatening our health, it has also threatened the economic livelihood of many people. Due to its complexity, it is not comparable with previous crises.

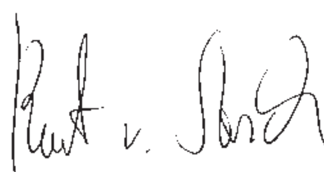
The capital markets reacted sharply to this novel virus. The rapid crash in March was followed by an equally rapid rally that was fuelled by historically unprecedented government aid programmes and central bank support.

Our main concern during the "hot phase" in the spring was to do our best to preserve the assets that had been entrusted to us. Temporary hedging of the equity portions of the mixed portfolios and the principles of the Flossbach von Storch Pentagram, which focus on high-quality investments and broad asset diversification among other things, helped us achieve this. We were not expecting the speed and magnitude of the recovery rally, which has mainly benefited cyclical companies with business models that are vulnerable to crises since November. As a result, we underperformed the general market during the upwards movement. Although this is unfortunate, we are not concerned, as phases like this occur repeatedly. We are convinced that our focus on high-quality equities with robust business models will continue to prove its value in the future.

Regarding bonds, an opportunistic approach is required due to the negative interest-rate environment. The traditional buy-and-hold-to-maturity approach no longer offers prospects of positive returns in the future. We achieved more than satisfying results in 2020 using an active bond strategy.

We would like to take this opportunity to thank you for the trust you have placed in us for many years, particularly during difficult market phases. It is not something we take for granted, but instead it acts as both an obligation and a motivation for us.

We would like to wish you and your family all the best for the New Year.
In particular, stay healthy!



Dr Bert Flossbach | Kurt von Storch | Dirk von Velsen

REVIEW

The word "weird" is commonly used to mean strange, but can also be interpreted as peculiar, odd, wacky, bizarre or crass. The year 2020 lives up to each of these attributes in some way. It will be remembered for a long time to come as an outlier, as a catalyst for developments already underway, and as a watershed.

Ironically, record-high debt was accompanied by record-low interest rates and government bond yields.

Economic, interest-rate and stock-market forecasts have scarcely followed such an absurd path as in the pandemic year 2020. It began full of confidence, as shown by the positive beginning of the year recorded by stock markets. This came to a sudden end when the Coronavirus spread to Europe, leading to one of the worst crashes recorded by stock markets with share-price losses of up to 40 per cent in just four weeks. The subsequent recovery was just as large and unexpectedly rapid. Governments used an historically unprecedented combination of fiscal and monetary policy to implement gigantic aid programmes that were readily funded by central banks. Initial fears of a financial crisis did not come to pass and the sharp economic downturn was quickly followed by a strong recovery. An impressive year-end rally began when the German company BioNTech, together with its US partner Pfizer, announced on 9 November that it had developed a highly effective Covid-19 vaccine. The prospects of an imminent return to normal day-to-day life caused some stock markets to rise to new highs, in spite of a renewed lockdown in December.

The same happened to the budget deficits and debt ratios of many countries, which soared along with the figures for the Coronavirus crisis. The USA had a deficit of USD 3.132 trillion in the fiscal year just ended, equal to around 15 per cent of gross domestic product (GDP) or more than three times the deficit in the previous year. Ironically, the debt explosion was accompanied by record-low interest rates and government bond yields, as central banks left no doubt as to their readiness to support the economy by keeping interest rates low for the long term.

Developments in the eurozone could also be described as peculiar or odd: at the beginning of the pandemic, concerns that differences in the effects on the member state economies might threaten the solidarity of the eurozone caused the risk premiums for Italian and Spanish government bonds to rise sharply. A turnaround occurred, however, during the course of the crisis, with yield spreads falling to their lowest level since the financial crisis of 2008. This

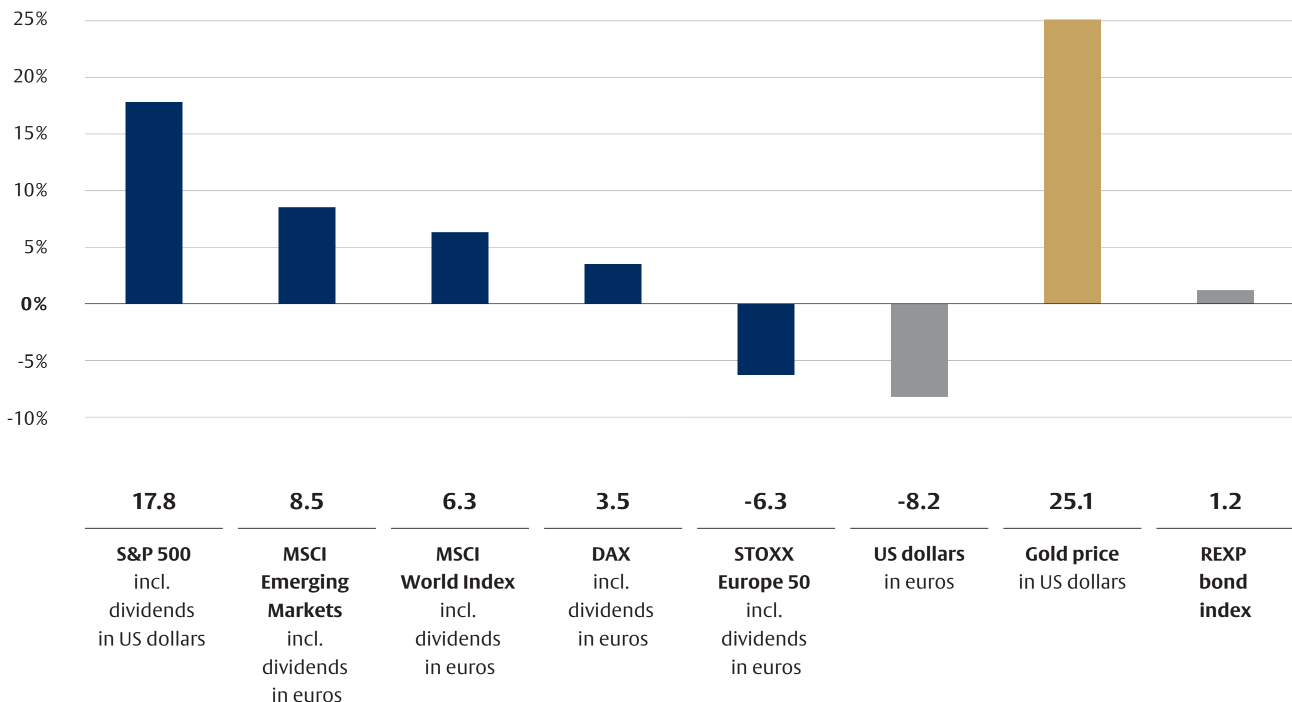
Concerns that the pandemic might pose a danger to the euro gave way to confidence that eurozone solidarity is now becoming stronger.

was also likely an important reason for the increased strength of the euro and weakness of the US dollar, which fell close to 10 per cent, significantly reducing the price gains earned on US equities by euro-based investors.

The pandemic year 2020 accelerated the trend towards digitalisation. This is also shown by the list of stock-market winners, with some prices reaching year-end levels that already reflect highly optimistic future expectations and set a very high bar for future revenue and earnings growth.

The upward trend in the gold price was also accelerated, leading to a record high of USD 2,075 in August. This was followed by a period of consolidation that caused the price to temporarily fall below USD 1,800 at the end of November. The year still ended with an increase of around 25 per cent, which was reduced to 15 per cent when calculated in euros due to the weakness of the US dollar. The performance of gold producer equities was unusual. In spite of an explosion of earnings and cash flows during the year, their prices did not rise more than the price of gold.

Figure 1 **Capital market performance 1 January to 31 December 2020**



17.8	8.5	6.3	3.5	-6.3	-8.2	25.1	1.2
S&P 500 incl. dividends in US dollars	**MSCI Emerging Markets** incl. dividends in euros	**MSCI World Index** incl. dividends in euros	**DAX** incl. dividends in euros	**STOXX Europe 50** incl. dividends in euros	**US dollars** in euros	**Gold price** in US dollars	**REXP bond index**

Source: Bloomberg, Flossbach von Storch, data as at 31 December 2020
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OUTLOOK

The unexpectedly quick arrival of vaccinations against the Coronavirus has fuelled hopes that 2021 will see an overall return to normality. The year just ended, however, has shown that positive and negative surprises that affect the magnitude and timing of an economic recovery can occur at any time. This is also true of individual economic sectors and companies that would be affected to different degrees.

In any case, stock markets long ago began pricing in a return to a new normal that includes both a significant economic recovery and a permanent change in consumption and investment behaviour.

The new normal also includes national debt, which has exploded due to the Coronavirus, and central banks that are ready to fund the mountain of debt as cheaply as possible over the long term – in the best case at zero cost.

The Coronavirus has opened the door to a debt union

In a village where each household is liable for all the others, even thrifty villagers soon notice that they personally benefit very little from their self-imposed frugality. Why save if they are jointly liable with the other villagers? Why shouldn't they borrow too, especially since it doesn't cost anything? The frugal villagers therefore adjust their expenditures to match the behaviour of their less-restrained neighbours, leading to an increasingly unrestrained accumulation of debt.

As a result of the Coronavirus, the previously thrifty households are now also living on credit, making it difficult for them to demand that the others practise budget discipline.

The creditors are not worried. Due to the joint liability, they are prepared to lend at a somewhat higher rate to the less creditworthy villagers, since the community as a whole is ultimately liable. There is no reason for concern as long as the level of debt for the entire village still appears manageable. And even further increases in debt create little risk of the loans not being repaid, since one of the creditors is a bank that feels especially committed to the village and wants to ensure the continued solidarity of the village regardless of the circumstances. The bank views itself as a lender of last resort, which means it will buy the village loans from other institutions in an emergency. Since it is not a normal bank and can print money with no limit, there is also no limit to the amount it can purchase. Provided the owners agree, it uses self-created money to offset any shortfalls in its balance sheet due to losses. It is good that the individual households in the village own the bank, even though their ownership shares are different. The villagers repeatedly had differences of opinion in the past on how much the bank could help households with especially high levels of debt. Due to the Coronavirus, however, the situation has changed, because the previously thrifty households are now also living on credit, making it difficult for them to demand that the others practise budget discipline. The long-controversial village bonds issued by the mayor on behalf of the entire village community also became acceptable as a result.

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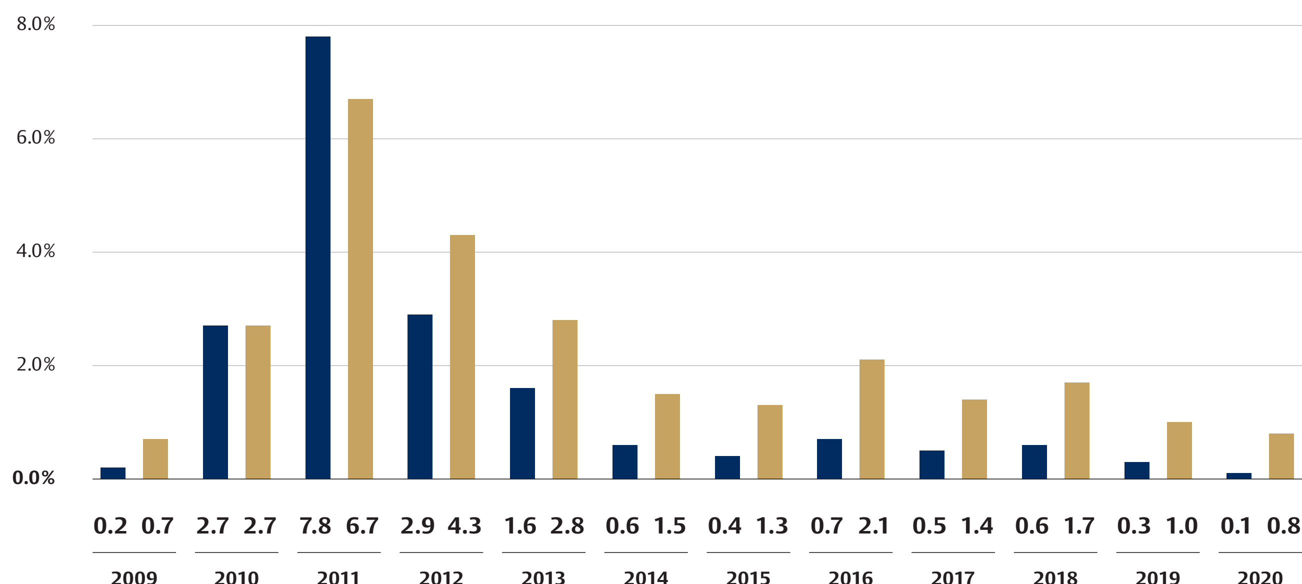
The village is the eurozone, the households are the individual countries, the lender of last resort is the European Central Bank (ECB) and the village bonds are the newly issued EU bonds.

The ECB announced it would fight eurozone fragmentation, thereby helping to reduce spreads.

ECB President Christine Lagarde recently made it unmistakably clear again that eurozone fragmentation had to be avoided at all costs. She was referring to large differences in the funding terms for individual eurozone countries due to large differences in government bond yields. After a major increase in yield differentials, or spreads, at the beginning of the Coronavirus crisis that seriously threatened to put the solidarity of the eurozone at risk, spreads decreased significantly during the later course of the year. The difference between German government bonds (Bunds) and a "southern eurozone bond" (average of Italy, Spain and Portugal) was just 0.8 percentage points for 10-year government bonds and 0.1 percentage points for two-year government bonds at the end of 2020, which is remarkable given the especially strong economic downturn in Southern Europe (see Figure 2).

Figure 2 **The eurozone crisis has passed**
Yield differentials close to zero again in the eurozone



Credit spread for a "southern euro bond"* versus a German government bond of the same maturity on 31 December of each year for: Two-year government bonds 10-year government bonds

* Equally weighted average of Italian, Spanish and Portuguese government bonds.

Source: Refinitiv, Flossbach von Storch, data as at 4 January 2021

Past performance is not a reliable indicator of future performance.

The PEPP allows the ECB to purchase bonds from the most highly-indebted eurozone countries to prevent yields or risk premiums from increasing.

Spreads are now at their lowest level since the beginning of the eurozone crisis at the end of 2009. To ensure that they stay there, the ECB increased its Pandemic Emergency Purchase Programme (PEPP) to EUR 1.85 trillion and instituted a much more flexible purchasing strategy that intentionally deviates from the capital key that previously tied half the volume of bond purchases to the GDP of the country concerned and half to the population size. The ECB can now systematically purchase bonds from the most highly-indebted eurozone countries and prevent yields or risk premiums from rising. To be consistent, the ECB would also have to ignore the capital key in future purchase programmes unrelated to the pandemic in order to fight eurozone fragmentation. Although this is clearly an indirect form of government funding, it could dispel the concerns that northern eurozone countries have about the future effects of the pandemic, which is having a particularly large impact on the southern eurozone countries. If ECB President Christine Lagarde is successful, the risk of the eurozone breaking up would be avoided for a long period to come.

The pandemic cleared the way for an informal liability and debt union. This also strengthens international investor confidence in the solidarity of the euro, even though growth prospects continue to be poor.

The weak points in the euro have been patched for the time being, which also makes it a viable alternative to the main reserve currency, the US dollar, particularly since the eurozone debt ratio is still lower than the USA or Japan.

The investment security created by the ECB is slowly undermining the capital market’s allocation mechanism.

Informal joint liability, however, is still not a true fiscal union comparable, for example, to the homogeneity of the US-dollar area. The euro is still fragile compared to individual country currencies and is being held together by a central bank that is operating at the limits of its authority. Due to the investment security created by the ECB, market participants are no longer appropriately taking into account the differences in creditworthiness between countries. This is slowly undermining the capital market's allocation mechanism and could lead to a race of increased borrowing in the eurozone. The artificial stability of the euro carries the seeds of a new destabilisation that will take place if the debt level in some countries gets completely out of control. But this is not a problem specific to the euro – it is a global problem. All the world's major currency areas are recording large budget deficits and rising debt ratios that are, of course, being funded by the central banks. The US deficit shows the magnitude and importance of the central bank as the lender of last resort.

The USA had a budget deficit of USD 3.132 trillion in the fiscal year just ended (September 2020). That is around 15 per cent of GDP – or more than the deficits in the previous four years combined and more than twice the deficit in 2009,

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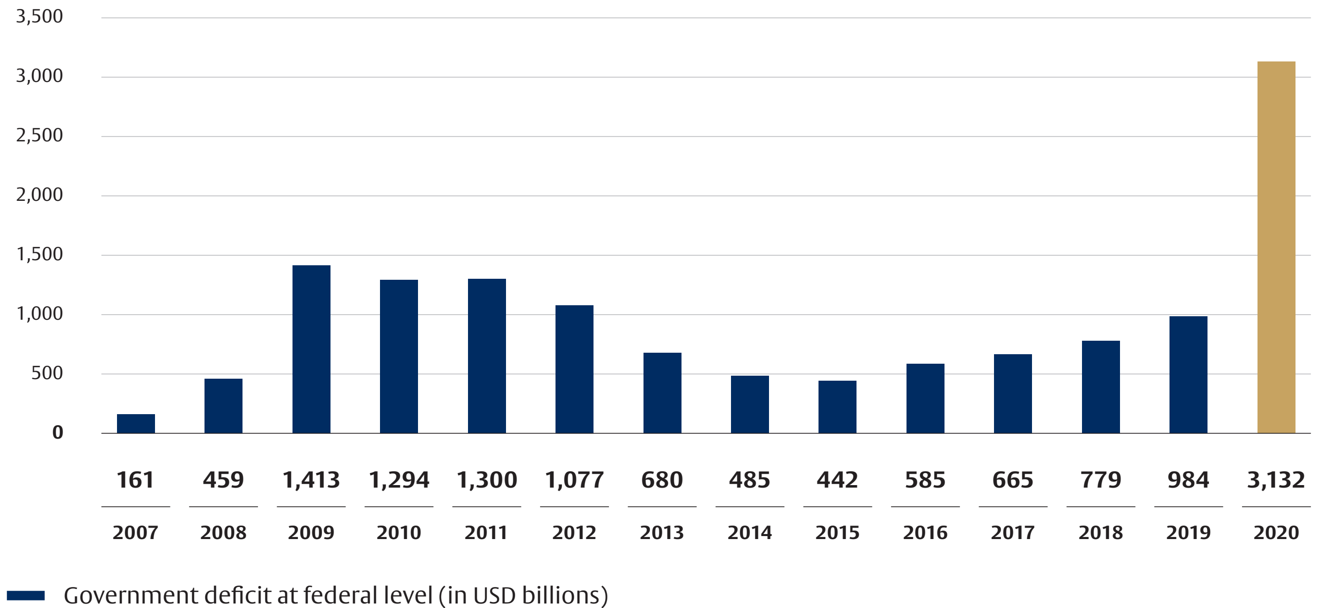
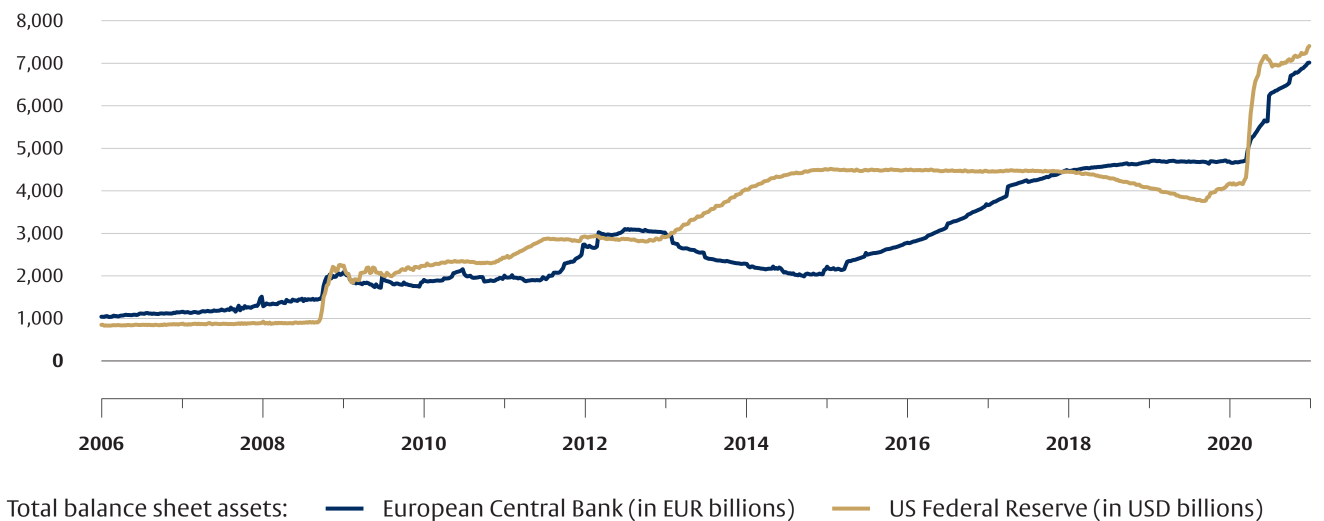
Figure 3 **Deficit spending at its best**
US budget deficit since fiscal year 2006/2007, in USD billions



Source: Bureau of the Fiscal Service, Congressional Budget Office, Flossbach von Storch, data as at 4 January 2021

Figure 4 **Coronavirus effect: purchase programmes inflate central bank balance sheets**
The US Federal Reserve has purchased more than USD 2 trillion in Treasuries since the beginning of March



Source: Refinitiv, Flossbach von Storch, data as at 4 January 2021

A previously unimaginable combination of fiscal and monetary policy made it possible to fund the enormous budget deficits.

when the aftermath of the financial crisis had to be dealt with. Funding for all of this has been made possible by a previously unimaginable combination of fiscal and monetary policy. Central banks are providing as much funding as governments need. This form of government funding will reach a limit at some point, such as when people lose confidence in bank money that can be created without limit.

The US Federal Reserve (Fed's) balance sheet has increased from USD 0.9 trillion to more than USD 7 trillion since the financial crisis in 2008 and the ECB's has increased from EUR 1.3 trillion to EUR 7 trillion. Figure 4 on the previous page shows the dramatic increase in the Coronavirus year 2020. In the last 12 months alone, the Fed’s balance sheet has increased almost the same amount as the previous 12 years. Although the ECB’s balance sheet did not grow quite as fast, it was already at a higher level at the start of the year.

Understandably, few people are interested in changes in central bank balance sheets and therefore aware of this trend. An erosion of confidence would only occur if money were to lose a significant amount of its value, year after year. It would not occur if there was a large increase in central bank money, since this is essentially just the monetary base, that is, bank deposits with the central bank.

Growth of the money supply accelerated dramatically in 2020 due to highly expansive fiscal policy.

The M1 money supply, which includes cash in circulation and demand deposits of companies and private households, is much more relevant and useful for inflation. Unlike central bank money, it has recorded a relatively steady and unspectacular increase over a long period of time. It grew at an annual rate of 6.3 per cent in the USA from the financial crisis in 2008 to the end of 2019, and an annual rate of 7.3 per cent in the eurozone. This changed dramatically, however, in 2020, with an increase of close to 30 per cent in the USA, and 12 per cent in the eurozone by the end of October (see Figure 5).

The sharp increase in 2020 was due to increased bank lending and government helicopter money (special pandemic payments to citizens). People retained a large part of the increase in the form of increased savings, however, thereby keeping it out of circulation in the economy (see Figure 6). In Germany, the savings rate was still 16 per cent of income in the third quarter – a value never achieved before the Coronavirus crisis.

Excessive growth in the money supply is therefore more a necessary condition for inflation, not a sufficient condition. This situation, which John Maynard Keynes called a liquidity trap, is part of the reason why consumption and investment demand have so far remained significantly below their potential level and not caused an increase in the price of goods and services.

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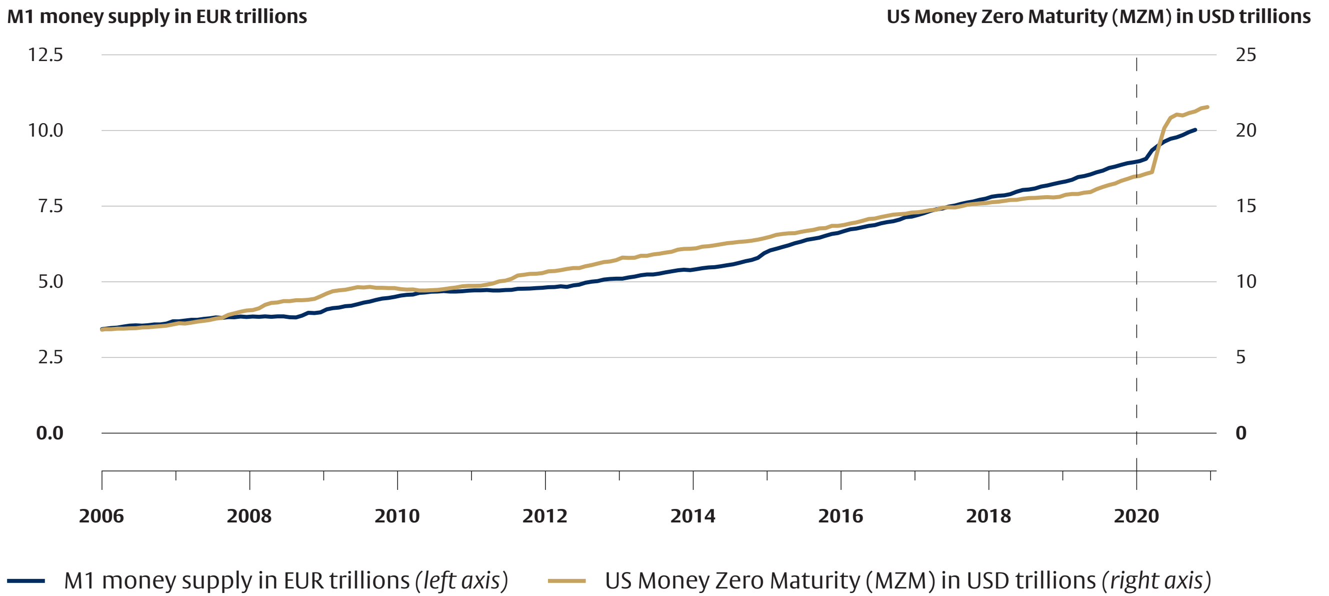
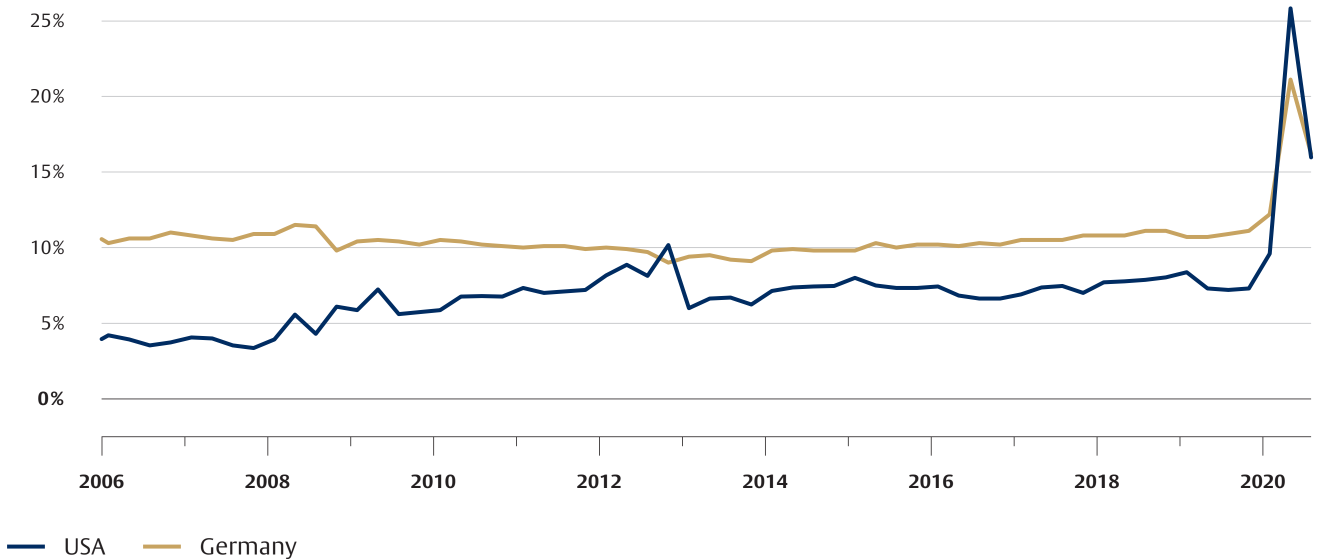
Figure 5 **Coronavirus increase: money supply growth in 2020**
M1 money supply in the eurozone and MZM in the USA



Source: Refinitiv, Flossbach von Storch, data as at 4 January 2021

Figure 6 **Liquidity trap: Coronavirus saving**
Savings rate increases in spite of, or even because of, the low level of interest rates



Source: Refinitiv, Flossbach von Storch, data as at 4 January 2021

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When there is no inflation, people feel no need to be concerned about the value of their money.

This could change if immunisation of the population against the Coronavirus this year triggered a boom in demand for some of the most strongly missed pleasures in life (in particular travel) and this in turn caused the consumer price index to rise. But this could also be temporary in nature, since a sustained inflationary increase requires a significant increase in wages or a permanent shortage in the supply of goods. The latter appears rather unlikely, in spite of an increase in corporate bankruptcies due to the Coronavirus, and there also appears to be no increase in inflationary pressure due to wages. However, as increasingly realised in previous years, when there is no inflation people feel no need to be concerned about the value of their money. Money hoarding and non-interest bearing deposits only seem foolish to people when there is a significant, sustained increase in prices. We are, however, still far from that point, although how far is unknown.

We know, however, that central banks cannot put the genie they summoned back in the bottle again. Using interest-rate increases to fight inflation will no longer be possible in the future, as the increase in interest payments would ruin many countries, companies and private debtors.

Potential solution: financial repression

The so-called financial repression in the USA between 1942 and 1954 can serve as a blueprint for countries to reduce their debt ratios.

Central banks will therefore have to maintain their low interest-rate policy. They can only hope that a combination of moderate inflation and low interest rates will bring debt ratios back into line without causing a collapse in the financial system. There is, after all, a type of blueprint for this. The USA dramatically reduced its debt ratio during the so-called financial repression from 1942 to 1954 by setting interest rates to 0.375 per cent for short-maturity and 2.5 per cent for long-maturity Treasuries. The economy was booming at the time and the average inflation rate during this period was around four per cent, although it fluctuated considerably within a range of negative three per cent in the summer of 1949 to almost positive 20 per cent in March 1947.

The debt ratio reached a high of 119 per cent at the end of 1946, and then fell to 69 per cent by 1954. This occurred because the nominal economic growth rate was around seven per cent p.a. during this period (real growth rate 3.1 per cent, inflation 3.9 per cent) and low interest expenses reduced the burden on the government budget. Germany was forced to use another method to reduce its debt ratio, namely a currency reform combined with compensation for real-estate owners.

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Potential solution: perpetual debt machine

When debt no longer has any cost, any level of debt is viable.

Given the ultra-low level of interest rates and steady decline in the interest burden, the question is whether the high-debt countries have to reduce their debt ratios at all. If debt no longer has any cost or even provides additional income in the form of profits from bond issues (zero coupon bonds issued at a price above the par value of 100), then any level of debt is viable, at least if this situation is permanent. For example, the 10-year zero coupon German Bund issue at the beginning of the year with a planned volume of EUR 25 billion is expected to produce an issuing profit of EUR 1.25 billion.

This will be recorded as an issuing profit or interest income in the 2021 federal budget. The German federal government is planning to issue a total of EUR 222 billion in new bonds in 2021 (not including money market securities), which would generate interest profits of around EUR 10 billion based on the current level of yields. Although the amounts are smaller, almost all EU countries are now earning profits like these. In Germany, yields are now negative for maturities of up to 30 years, which means practically every new issue generates interest profits.

If Austria were to issue another hundred-year bond at the current terms, even children born in 2021 would bear no repayment burden and practically no interest burden.

Thirty years, however, is only one generation. It has to be a bit longer for their children and grandchildren to also be freed from the burden of debt. Austria, for example, issued a one hundred-year bond in June 2020. The coupon was 0.85 per cent and the issue had a volume of EUR 2.8 billion. The interest burden for Austrians is just EUR 24 million per year. It would, however, be even more attractive today, as the bond currently has a yield of just 0.45 per cent. That means if Austria were to issue another bond like this today, it could borrow at a rate of 0.45 per cent, or practically no cost, for the next hundred years. Even children born in 2021 would bear no repayment burden and practically no interest burden for such a bond.

The EU also finds long-maturity low and zero coupon bonds attractive and plans to raise a total of EUR 850 billion from capital markets on behalf of all member states for its Next Generation EU and SURE (Support to mitigate Unemployment Risks in an Emergency) development programmes. Although community bonds like this have long been frowned on, the pandemic also led to a major turning point in this regard. More than EUR 100 billion in new bonds could be issued in 2021 alone, at yields that will likely be insignificantly higher than German Bunds, which means less than zero for maturities up to 30 years. The perpetual debt machine therefore appears to be perfect.

A perpetual debt machine assumes that central banks freeze government bond yields.

The zero and negative interest-rate regime encourages the view that debt is costless – and that one could even use it to earn one's way out of the crisis, which actually does appear possible given the negative yields on long-maturity bonds. This could, at least, apply to people over 50 (by far the most important voter group) if countries continue to cover their funding needs with long-maturity zero coupon bonds in coming years, thereby reducing the interest burden to zero. A perpetual debt machine like this, however, assumes that central banks keep key interest rates low for the long term and freeze government bond yields, even if inflation increased significantly again some day. A perpetual debt machine therefore assumes long-term financial repression, supplemented by debt haircuts in the extreme case.

Debt forgiveness often provides only temporary relief and creates false incentives to live beyond one's means.

Simply cancelling bonds to reduce the mountain of debt – a solution considered unthinkable years ago – was recently introduced into public debate by Southern European politicians. Debt forgiveness, however, is a double-edged sword. It often only provides temporary relief and increases the incentive to live far beyond one's means. Without structural reforms that address the root of the problem and ensure sustained growth, countries are often in a similarly bad situation a few years later. There is also a loss of confidence among creditors, who turn their backs on the country for a long period of time. Since central banks are now the countries' biggest creditors, however, the problem could be solved if central banks cancelled government bonds in their balance sheets and filled the resulting gaps with money they created themselves. The process could even be repeated as often as desired, as long as the citizens in those countries do not take offence and do not lose confidence in bank money that can be created without limit. But it is questionable whether people would accept such a radical perpetual debt machine. A currency reform would probably take place in the end.

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INVESTMENT STRATEGY

Bond investors are feeling the downside of permanently low interest rates. Negative yields on government bonds, zero yields on good-quality corporate bonds and even meagre yields on poor-quality bonds – this is not the stuff that bond investor dreams are made of, at least not those planning to hold the bonds to maturity.

Top-quality zero-coupon government bonds can no longer be considered a predictable source of income. At best, they are now only important as an insurance against an economic collapse or other extreme risks. This puts them in competition with gold. Gold, however, offers better inflation protection in the long term, in exchange for higher price volatility in the short term.

Central banks dug themselves even deeper into the world of zero and negative interest rates in the Coronavirus year 2020. One could say this was unavoidable, because they wanted to buy bonds during the crisis to help countries and prevent a financial market collapse. In the meantime, the realisation has grown that the low interest-rate environment will continue for a long time to come. This does not mean, however, that bond markets, sedated with monetary policy, no longer involve any risk.

Investors who want to protect, or even increase, their assets over the long term cannot ignore equities. Although this is not new information, it is increasingly being realised across a broad front. If, however, more and more people believe the same thing and act accordingly, the danger naturally increases of something unexpected happening, such as prices falling more sharply from the high level already reached.

There are three reasons this could occur:

- First, a sustained collapse in corporate earnings.
- Second, a sustained increase in interest rates.
- Third, valuations that are much too high.

Governments have signalled they will not reduce their efforts in the fight against a possible recession and will use further aid packages to provide support for citizens and the economy if the situation requires it. They are willing to accept the related budget deficits and further increases in debt and are supported by the arguments of many academics who feel the resulting debt problem presents little danger or can be solved.

With respect to the central banks, they have made it unmistakably clear that they are ready to ensure favourable funding terms in order to limit the burden due to any economic stimulus and aid programmes. ECB President Lagarde even explicitly asked governments to use the cheap money to keep the economy running. Interest-rate increases are therefore ruled out for the long term, and rising bond yields that would have a negative effect on equity valuations should also not be expected.

The third risk, namely valuations that are much too high, is directly related to the first two risks. If prices remain unchanged, equities become more expensive if there is a (sustained) decrease in earnings and an increase in interest rates. The companies in the MSCI World equity index are currently valued at 21 times expected earnings for the next 12 months. One has to take into account that analyst earnings forecasts assume a significant recovery in earnings compared to 2020. If these expectations prove to be somewhat accurate, equity valuations would not be particularly low compared to the past, but they would be far from the excessive valuations a good 20 years ago.

In addition, interest rates are considerably lower today and government bond yields have fallen sharply, thereby greatly reducing the discount rate for future earnings and increasing their present value.

Although at close to five per cent (the inverse of 21), corporate earnings yields are considerably lower than in previous years, the difference of around four percentage points compared to 10-year US Treasuries, which are currently yielding only 0.9 per cent, is still large (see Figure 7). The yield advantage versus negative yielding German Bunds is even greater, at 5.4 per cent.

This is, however, just an average value. Although it might act as an indicator for the overall market, it does not show what is happening below the surface. The valuations of

Figure 7 **Equities: just as expensive (or attractive) as 30 years ago**
Equity earnings yield (MSCI World) versus US bond yield

* Based on expected earnings for the next 12 months.

Source: Refinitiv, Flossbach von Storch, data as at 4 January 2021

Expected earnings are based on specific assumptions. Actual results may differ considerably.
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technology companies, for example, whose index weight has increased steadily in previous years, have risen strongly. 2020 was a trend accelerator for these digitalisation winners. This led investors to be increasingly generous when valuing each dollar of current revenue and earnings, in the belief that these companies would have a wonderful future. The price increases for technology companies, some of them quite spectacular, are therefore primarily an indicator of increased optimism that moved the bar higher for future revenue and earnings growth – whether justified or not.

The many IPOs, some of them sensational, by companies like Airbnb and DoorDash that recorded up to triple-digit price gains on the first day of trading, also bring back memories of the technology bubble at the turn of the century. There was also a flood of so-called SPACs (Special Purpose Acquisition Companies), i.e. shell companies that go public as empty vehicles to invest the capital they raise in unlisted companies. Blank cheques like these represented half of the around USD 180 billion raised by IPOs in the USA in the year just ended.

In many cases, the companies are generating almost no revenue, to say nothing of earnings, and in especially blatant cases still do not even have a product. This includes the (future) electric lorry manufacturer Nikola, whose name cleverly refers to the electrical pioneer Nikola Tesla and, therefore, to Tesla shares. The price of the VectorIQ SPAC, which was listed in 2018, jumped from USD 10 to USD 15 after announcing in March that it intended to invest in Nikola. When the Nikola investment was approved at the beginning of June, excited investors could subscribe for new Nikola shares at USD 34 per share. The price then jumped to USD 80 in just four days, before going downhill. In September, accusations of fraud and complaints were made against Nikola founder Trevor Milton, who had to leave the company. Shortly before, he sold some of his shares to buy a ranch. The shares were still trading at USD 15 at the end of 2020, which nevertheless still represents a market capitalisation of six billion.

Mistakes like Nikola are, of course, not the rule. But the share-price jumps that it and many other stocks recorded would likely have been somewhat more restrained if millions of excited small investors had not discovered the stock market as an adrenalin-pumping real-time gaming platform in the pandemic year 2020.

So, in addition to giving the digital revolution a boost, the Covid-19 crisis also increased stock-market anticipation of this trend, leading to market capitalisations for many companies that still need to be earned.

The most spectacular example is electric car manufacturer Tesla, which is no longer considered a typical car manufacturer, but instead a full-blooded technology company. This electrical pioneer ended the year with a breathtaking market capitalisation of USD 669 billion. That means Tesla is worth almost as much as all the other US, European and Japanese automobile manufacturers, which have a combined value of around USD 800 billion (around USD 1,000 billion if Chinese manufacturers are included). Tesla had revenues of USD 28.2 billion in the last 12 months (to September 2020), compared to USD 1,533 billion for all other automobile manufacturers, excluding China. Tesla's earnings were USD 0.6 billion for this period, compared to USD 10.3 billion (amount reduced by the Coronavirus) for all other manufacturers outside China. The comparison shows that expectations for Tesla's future revenues and earnings are now extremely high. If, however, as Elon Musk announced, the company actually becomes the biggest automobile manufacturer in the world and can generate additional earnings from other services, they will not be as excessive as they appear at first glance. This illustrates the dilemma that exists when valuing fast-growing technology companies during a digital revolution. Unlike the turn of the century, the prices of technology companies are not being driven by clicks and euphoria from ad hoc announcements alone, but instead by long-term revenue and earnings potential. The low level of interest rates also helps by significantly reducing the discount factor for future earnings, thereby

Table 1 **Tesla is worth almost as much as all US, European and Japanese automobile manufacturers combined**
All figures in USD billions

	Market capitalisation	Revenue Sept 2019 to Sept 2020	Net earnings Sept 2019 to Sept 2020
Tesla	**668.9**	**28.2**	**0.6**
EU, Japan, USA total (ex Tesla)	**808.9**	**1533.0**	**10.3**
Toyota	251.5	241.4	13.3
Volkswagen	100.3	248.1	5.1
Daimler	76.0	173.4	0.0
General Motors	59.6	115.8	3.4
BMW	57.3	110.8	3.9
Honda	50.5	120.4	2.3
Ferrari	44.5	3.7	0.6
Ford	35.0	130.9	-0.2
Fiat Chrysler	28.5	98.3	0.0
Peugeot	24.5	68.0	2.2
Nissan	22.9	73.9	-9.9
Suzuki	22.7	27.9	1.0
Subaru	15.4	27.4	1.0
Renault	12.9	50.8	-9.3
Mazda	4.2	26.3	-0.9
Mitsubishi	3.1	15.9	-2.2
China total (7 Chinese automobile manufacturers)	**193.1**	**89.9**	**4.9**

Source: Bloomberg, Flossbach von Storch, data as at 4 January 2021
Past performance is not a reliable indicator of future performance.

greatly increasing their present value. **One could therefore say that the future is simply much more expensive today than it was in the past.** This is the main reason companies with outstanding long-term growth prospects recorded above-average increases in valuations. On the other hand, it also means that disappointing performance almost inevitably leads to inordinately large decreases in valuations and, therefore, sharply falling share prices.

This applies not only to equities in the technology sector, but also to companies ranging all the way from the medical technology sector and fintechs to individual industrial and consumer companies.

One therefore has to maintain a balance between companies with especially good growth prospects but comparatively high valuations (based on current

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revenues and earnings), and companies with resilient earnings but modest growth potential whose valuations are correspondingly lower. The “growth” and “value” categories frequently used for equities can be misleading, as stocks are mostly classified based on their current price-to-earnings (PE) ratios. Equities with high PE ratios are lumped together as growth shares and those with low PE ratios are considered value shares. Past history, however, shows that high valuations do not necessarily mean high growth and low valuations are often not a bargain, but instead a “value trap”.

In the final analysis, however, investors want to identify undervalued equities, that is, companies whose future earnings are not yet appropriately reflected in the current price of their shares. Therefore, instead of the current share price or valuation, each analysis should start with the quality of the company, that is, the reliability and magnitude of the company’s earnings potential. This also naturally has a subjective component, since every earnings forecast is ultimately based on expectations. It is sufficient if the direction and approximate magnitude of future performance can be anticipated reasonably accurately. The fact that this is not always possible is just the nature of the problem and is an argument in favour of balanced diversification – even if you feel that having all your eggs in a certain basket, namely the one that recently performed particularly well, is the best idea.

This is especially true in a world where the old rules no longer appear to apply, where creditors have to pay in order to lend to their debtors, where central banks ask governments to borrow as much as possible and the value of the debt increases the more there is, and where an economic collapse triggers a stock-market boom.

What a weird world!

Dr Bert Flossbach

Cologne, 4 January 2021

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