

Advertising Material

Capital Market Report 1st Half 2020

**All In**

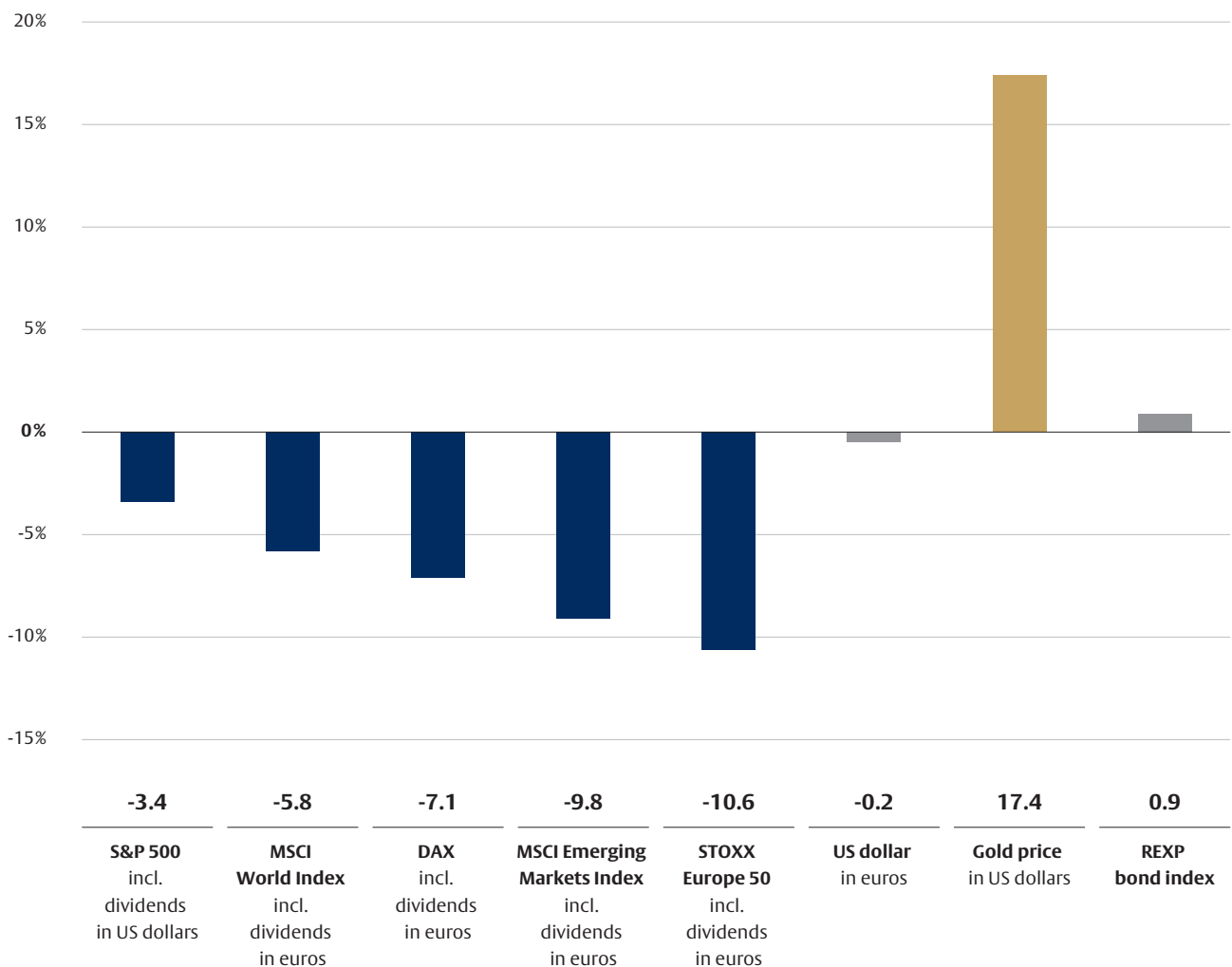


Flossbach von Storch

## REVIEW

If you woke up on 30 June after sleeping half a year and took a look at stock prices, you would assume that stock markets had recorded a completely normal, moderate correction following the large price gains in 2019, and would suspect this was due to a small economic slowdown.

Figure 1 **Capital market performance 1 January to 30 June 2020**



Source: Bloomberg, Flossbach von Storch, data as at 30 June 2020

Past performance is not a reliable indicator of future performance.

The situation after the first half of the year would not, however, lead you to assume that the world had been hit by a pandemic that almost brought the economy and social life to a halt for several months, creating the biggest economic collapse in post-war history (see Figure 1).

If you went to sleep on 31 March knowing about the pandemic and large double-digit price losses and woke up three months later, you would assume that the virus had largely disappeared in the meantime or a vaccine had been found, so that the economy had recovered more quickly than expected. As we know today, this interpretation of the half-year figures is also incorrect.

In fact, the virus continued to spread and the economy collapsed even more than feared three months ago. But why did the stock market recover so quickly then? There are three reasons:

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Massive monetary and fiscal policy stimulus is supporting the stock market.

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1. Government aid packages of an unprecedented size.
2. A rapid, extreme reaction by central banks that created a sustained reduction in interest rates and a massive flood of liquidity.
3. Index performance that benefited from a few well-performing equities with large index weights, thereby creating a significantly better picture than the average for all equities.

The third reason is shown by the difference in the performance of individual sectors. The sector indices for pandemic losers, such as airline companies, oil and gas producers, banks, hotels/restaurants/leisure companies, are still showing a loss of 25 to 50 per cent compared to the beginning of the year. The many jobs and large revenues they represent make them an important part of the economy, but the comparatively low market capitalisation of these companies gives them far smaller stock-market index weightings.

The sector indices for pandemic winners, on the other hand, such as information technology and healthcare, performed considerably better and are even showing gains compared to the beginning of the year. Their high market capitalisation, however, has also kept the losses recorded by the most important equity indices, MSCI World and S&P 500, within limits.

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The five largest S&P 500 companies alone contributed five percentage points to the performance of the index.

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For example, the five largest companies in the US S&P 500 index (Alphabet, Amazon, Apple, Facebook and Microsoft) – i.e. one per cent of the equities in the index – represent more than 20 per cent of the index weights and contributed five percentage points to the index performance in this year alone. As highly Covid-resistant companies, they benefit in two ways: first, they keep short-term earnings losses within limits, while in some cases considerably improving

long-term earnings prospects. Second, a sustained low level of interest rates leads to an above-average increase in the valuations of stable growing companies, as discussed in more detail in the investment strategy section.

Gold was also one of the winners in the first half of the year. The frequently mentioned reason, namely that gold is a winner during crises, is, however, not responsible, or only indirectly responsible for the price increase of around 17 per cent. Instead, it is the expected consequences of the crisis, in particular the sustained low level of interest rates and flood of central bank liquidity, that are causing inflation to rear its head once again on the horizon.

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There was no previous model for the Coronavirus pandemic.

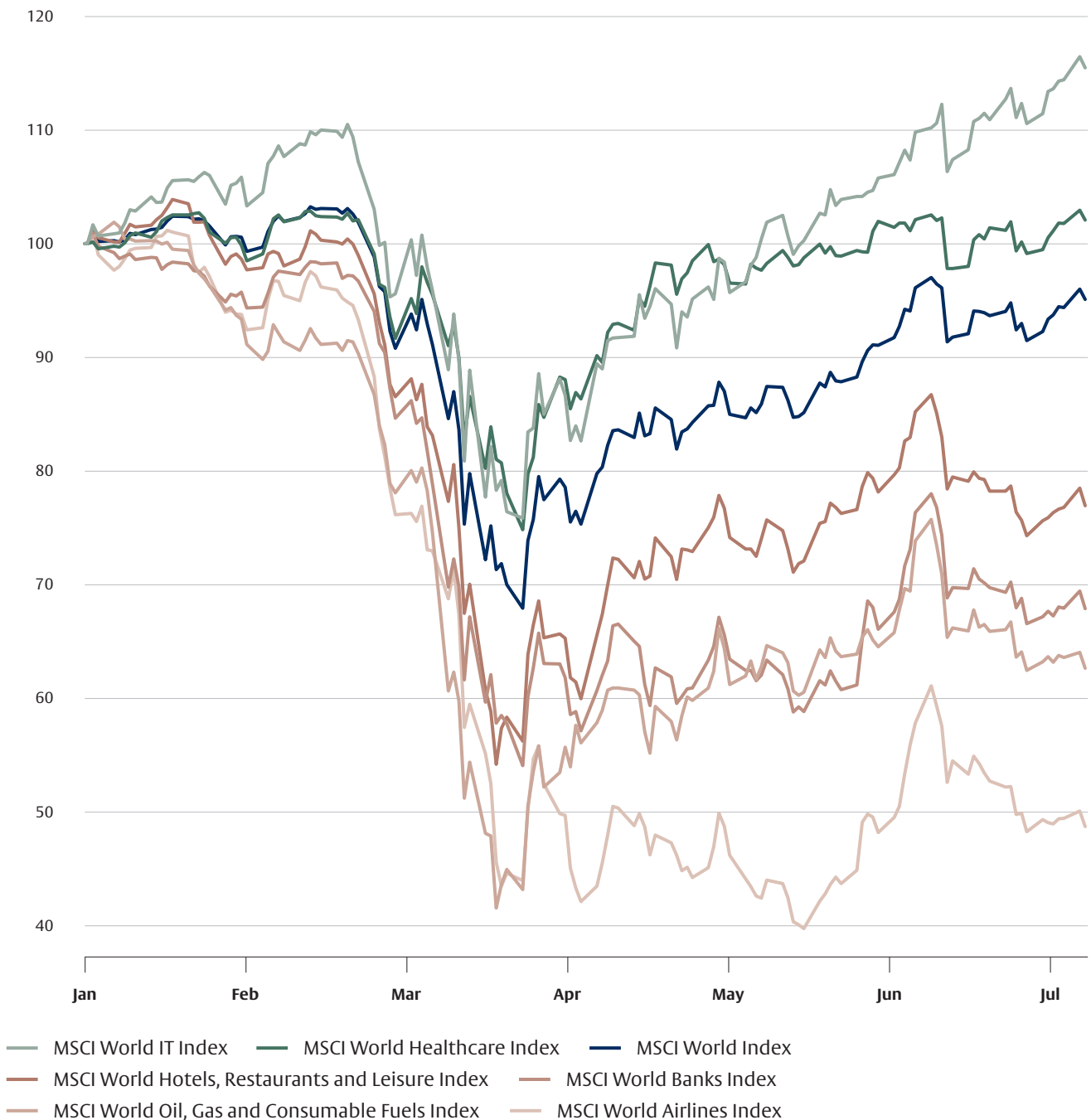
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Although history does not repeat itself, it does show similarities. There was no previous model for the Coronavirus pandemic. The financial crisis 12 years ago, however, could serve as a rough indication of the magnitude of the expected collapse in prices and the following recovery.

The partial hedge of the equity holdings in our multi-asset funds that we created in February was a precaution that the subsequent stock-market collapse showed to be correct. Since it generally takes a long time before a stock-market crash triggered by an economic collapse has bottomed out, it seemed advisable to wait before removing the hedge – particularly since the initial recovery is practically always followed by another wave of selling and news reports continued to deteriorate until the middle of April.

Although a second wave of selling did actually occur, it primarily affected sectors that were particularly hard hit by the crisis, as shown by the performance of the banking or airline indices in Figure 2. The equities in other sectors, on the other hand, in particular the highly weighted IT sector, pulled the market steadily higher. When it became apparent that government aid measures and central bank securities purchases were developing into a concerted “all in”, and that another market correction was becoming increasingly unlikely, we began to systematically remove and then finally fully eliminate the partial hedge of our equity holdings. Although our hedging strategy allowed us to limit the drop in fund prices during the collapse, it also reduced performance during the unexpectedly rapid and strong recovery that followed.

Figure 2 **Extreme differences in performance by individual sectors** – A comparison of MSCI World sub-indices (indexed to 01/01/2020 = 100)



Source: Refinitiv, Flossbach von Storch, data as at 9 July 2020

Past performance is not a reliable indicator of future performance.

## OUTLOOK

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# U, V, W, L or J?

The Coronavirus will remain, and continue to affect us, until effective vaccines and/or medications are available in sufficient quantities and all restrictions are finally removed. But things will not return to the old normal even then. A great deal will remain different after the crisis.

Changes in consumer behaviour, greater work flexibility, fewer business trips, new event and mobility concepts, expanded health and safety rules and greater government influence, combined with increasing debt and a long-term zero interest rate, are trends that were in some cases already apparent before the crisis, but are now taking place at a considerably faster pace. The most obvious change that we are all experiencing in our work, consumption and social environment is the accelerated trend towards digitalisation.

As a result, the much-discussed questions of how quickly the economy will recover after the coronavirus crisis and which letter of the alphabet best describes the course of the recovery are beside the point. For many people, it naturally matters whether the economic recovery looks more like a V or a U, that is, whether it quickly rises to its pre-crisis level again or has to pass through a long valley of tears first. A W-shape is also possible if a rapid upswing is followed by a second wave of infections with extensive lockdowns, or – less likely – an L shape in which all of the government aid packages and unlimited central bank support are unable to prevent a long-lasting recession. What looking at the overall economy or gross domestic product fails to reveal are the major performance differences lying below the surface. While some sectors are experiencing sustained suffering during the crisis

with an outlook best described by the letter L, other sectors are showing a long-term improvement in growth prospects that would be best described by the letter J.

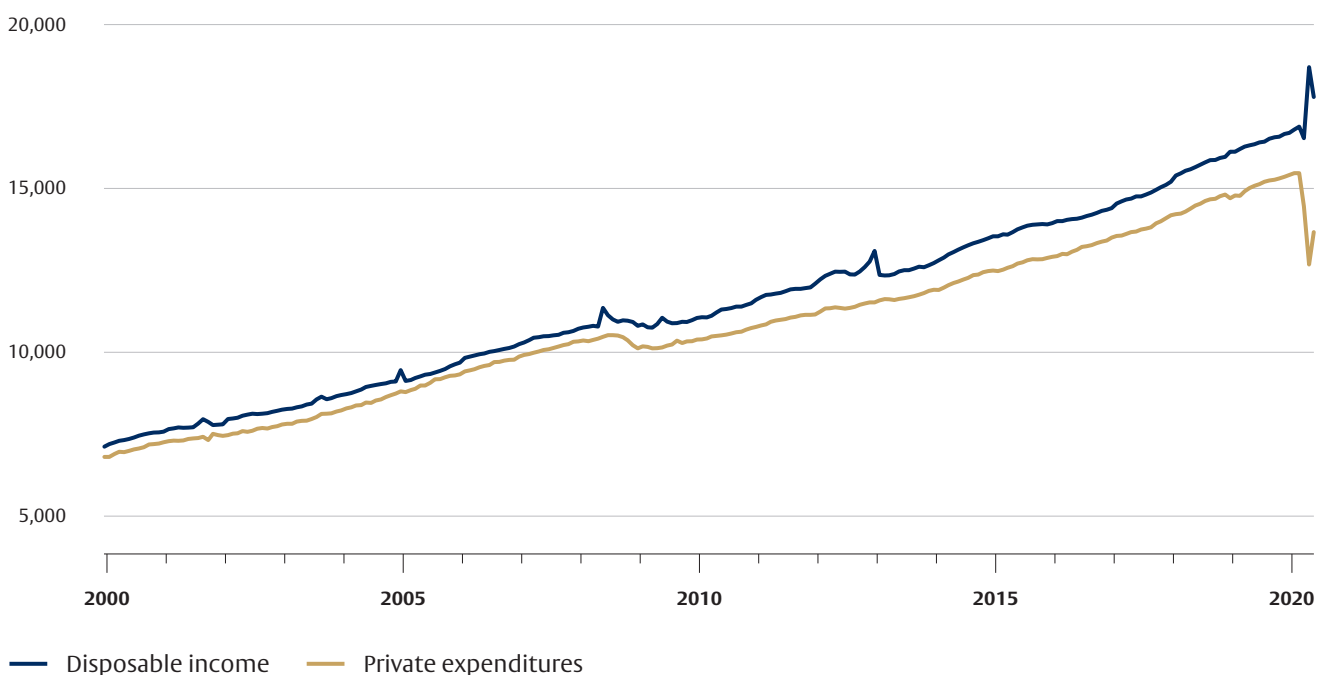
The number of jobs in these sectors and companies is small, however, compared to their market capitalisation and high weighting in equity indices, and it would be naive to think that a few dozen technology and pharmaceutical firms could maintain the world economy while the rest suffer. After all, they need people and companies with adequate financial resources to buy their products. Overall economic performance and job creation are therefore also important for these companies.

The performance of the overall economy will not mirror the almost V-shaped performance of stock markets, but will instead follow more of a U-shape. This will also have a direct effect on government budgets and debt, which will be pushed even higher by costly economic stimulus programmes and aid packages and can only be directly and indirectly funded by the central banks.

## All In

The US government has put together economic stimulus packages worth USD three trillion that can be further increased, if necessary. By 30 June, for example, under the USD 659 billion “Paycheck Protection Program” (PPP) alone, USD 521 billion in company loans had been provided at favourable terms allowing the loans to be fully or partially forgiven if certain criteria are observed, such as maintaining employee jobs.

Figure 3 **First save: Coronavirus reserve in accounts** – US consumers remain cautious, in spite of an increase in income (all expenditures in USD billions; annualised seasonally-adjusted monthly data)



Source: Refinitiv, Flossbach von Storch, data as at 9 July 2020

Past performance is not a reliable indicator of future performance.

## OUTLOOK

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The US aid programmes can at least limit the decrease in consumer expenditures.

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In addition, the “Federal Pandemic Unemployment Compensation” (FPUC) programme increases unemployment benefits by USD 600 per week, with the bizarre result that until 31 July at least, many US workers will receive more money for not working than they previously received from their jobs. The unemployment benefits were supplemented by USD 1,200 in “helicopter money” for all US workers earning less than USD 75,000 a year (double this amount for couples), plus a further USD 500 for each child. Although this did not prevent a reduction in consumer expenditures, it at least cushioned the decrease. Due to the uncertain outlook, a significant portion of this sudden bonanza was first saved, but could support consumption in subsequent months (see Figure 3 on the previous page).

No time was lost in the eurozone either. The German federal government abandoned its balanced budget within a matter of hours, and by the end of the period had approved a net debt increase of EUR 218 billion for the current year. President of the EU Commission, Ursula von der Leyen, presented a EUR 750 billion economic recovery programme funded by bonds to be guaranteed by the EU member countries. This variation of funding allowed long controversial euro or Coronavirus bonds to enter through the back door.

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In spite of the massive economic stimulus packages, the global economy will likely record its biggest post-war collapse in 2020.

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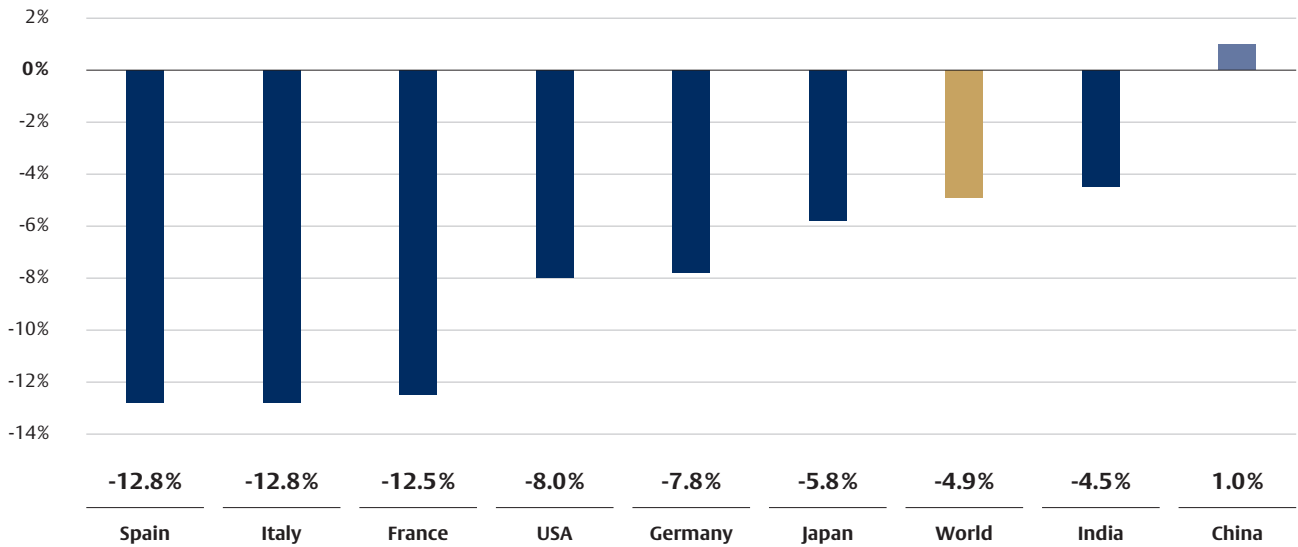
Worldwide, there are USD five trillion in fiscal measures affecting government budgets, supplemented by around USD 3.7 trillion in government guarantees. In spite of these massive economic stimulus packages, the global economy will likely record its biggest post-war collapse in 2020. The economists at the International Monetary Fund (IMF) recently revised their forecasts for global economic growth downwards from minus three to minus 4.9 per cent. With expected real growth of 1.0 per cent, China, the second largest economy in the world, will likely prove to be a rock in troubled waters that even German automobile manufacturers will cling to (see Figure 4).

It will likely be quite a few more years before this unique form of economic crash is repeated. Neither the European Central Bank (ECB) nor the US Federal Reserve (Fed) expect economic output in the eurozone or USA to approach 2019 levels again before 2022. And it will be considerably longer before the most seriously affected countries and sectors return to their pre-crisis levels. In any case, the collateral damage will only become apparent once government aid programmes run out and the number of insolvencies rises. Further debt-financed government aid packages will therefore likely follow. The maximum government debt limits for eurozone countries no longer apply in practice. Large amounts of new debt are now seen as a budgetary policy necessity for battling the effects of the Coronavirus, and funding no longer depends on the lending capacity of the capital markets. Instead, there is now no alternative to funding provided under the new central bank policy.



OUTLOOK

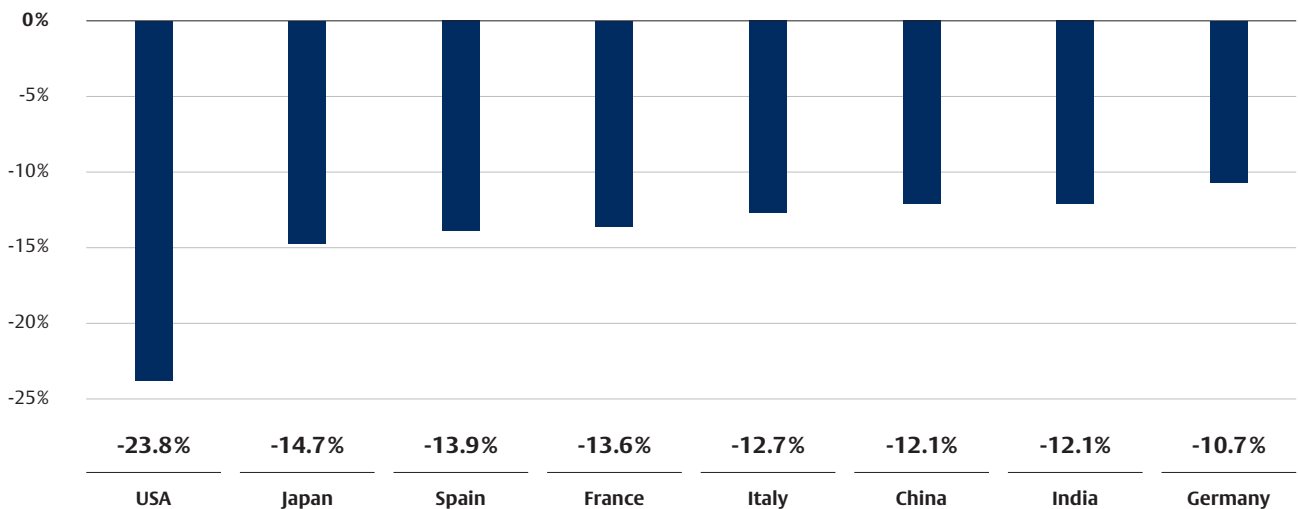
Figure 4 **A dismal year for the economy** – IMF estimates of global economic growth in 2020



■ Real economic growth

Source: IMF, Flossbach von Storch, data as at 9 July 2020

Figure 5 **Budget consolidation put on ice** – IMF estimates of total national budget deficits as a percentage of GDP (2020)



■ Total national budget deficit as a percentage of GDP

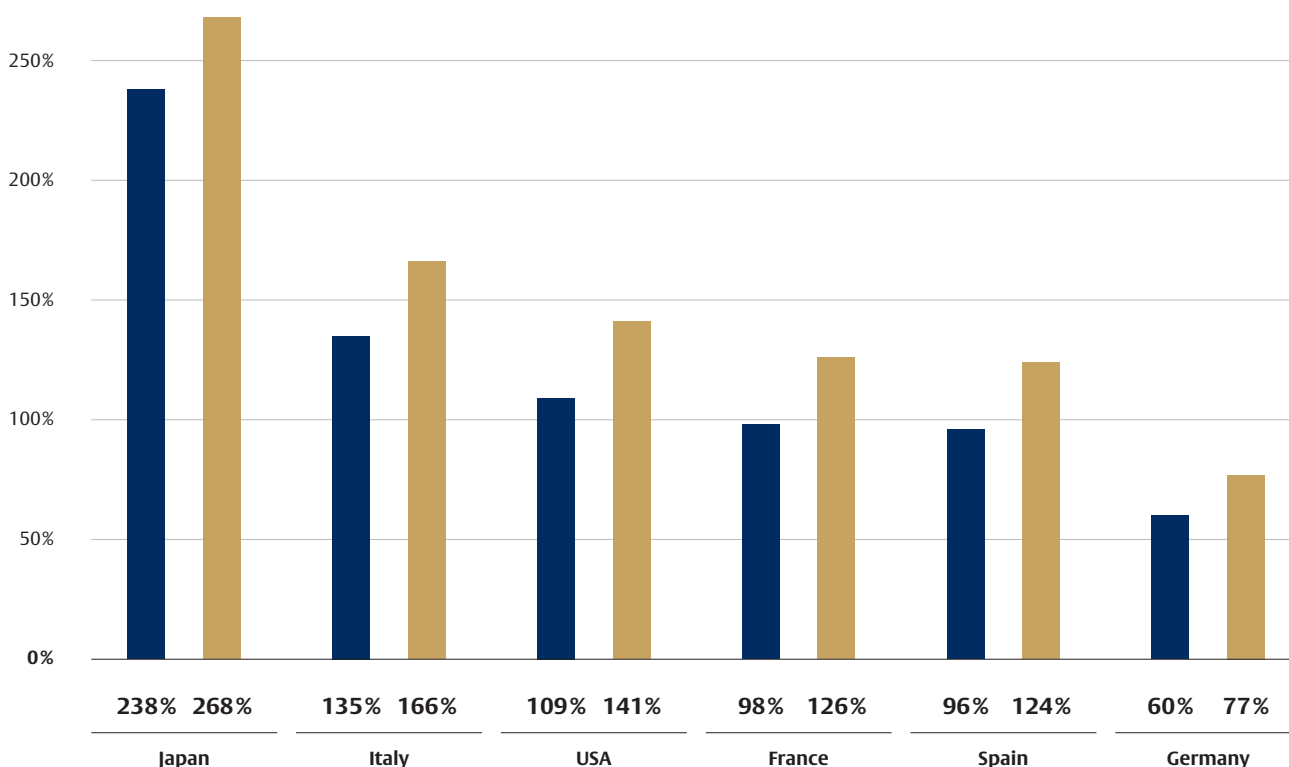
Source: IMF, Flossbach von Storch, data as at 9 July 2020

OUTLOOK

The budget deficits expected this year will drive national debt to record levels worldwide.

The budget deficits expected this year far exceed all historical amounts (see Figure 5 on the previous page) and are driving national debt to record levels worldwide. The IMF expects the US debt ratio to increase from 109 per cent of economic output to 141 per cent this year. The situation in the eurozone, on the other hand, where the national debt ratio is increasing from 84 to 105 per cent, still appears moderate at first glance. There are, however, large differences there. Italy, the third-largest economy in the eurozone, is expected to have a debt-to-GDP ratio of 166 per cent by the end of 2020 (see Figure 6). In Germany, the national debt is expected to increase around 17 percentage points to 77 per cent, a comparatively low level that will nevertheless likely continue to increase in coming years due to demographic change and decreasing German competitiveness.

Figure 6 **Japan shows the way** – Dramatic increase in national debt in 2020



National debt ratios as a percentage of GDP: 2019 2020\*

\* Estimates from the World Economic Outlook in June 2020

Source: IMF, Flossbach von Storch, data as at 9 July 2020

## OUTLOOK

Japan already began moving in the direction of these new large-scale amounts of debt more than 20 years ago. The reason it can live quite comfortably with its mountain of debt is simple. The average coupon on all outstanding Japanese government bonds is just 0.8 per cent, and will continue to fall in coming years. Since the Bank of Japan holds around half of the government bonds and transfers its interest income back to the government, the government's actual interest burden is even smaller.

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As the saviour of last resort, the ECB will further reduce the interest burden for EU countries with high levels of debt.

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The situation is not quite so favourable for the eurozone countries. The average coupon is currently 2.5 per cent for Italy's government debt and 1.4 per cent for Germany. As the saviour of last resort, the ECB initiated its Pandemic Emergency Purchase Programme (PEPP) in March to help further reduce the interest burden for EU countries with high levels of debt. The programme was increased by EUR 600 billion to EUR 1.35 trillion in June, will continue to at least the end of June 2021, and can be extended if necessary. In addition, a second asset purchase programme (APP) with monthly bond purchases of EUR 20 billion has already existed for a long time. The ECB will not hesitate to increase this programme essentially without limit in an emergency.

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The banks received EUR 1.3 trillion at an interest rate of minus one per cent from the ECB.

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Parallel to these bond purchase programmes, the ECB also used "targeted long-term refinancing operations" under its new TLTRO III programme to create more breathing room for eurozone banks suffering from the low level of interest rates. The banks received EUR 1.3 trillion in loans at an interest rate of minus one per cent (!) from the ECB. Although this was officially aimed at stimulating lending in the economy, the conditions for receiving this interest gift are very lax. All the banks have to show is that they have increased their volume of lending, regardless of the amount, by March 2021. A bank can therefore borrow several billion euros at a rate of minus one per cent and then invest most of it with the ECB again at a rate of minus 0.5 per cent. The difference of 0.5 per cent represents a risk-free return for the bank. For an investment in Italian government bonds, the interest-rate margin can even increase as high as two per cent depending on time to maturity.

The Fed is also going "all in". After taking three months to reduce its benchmark interest rate from two to zero per cent during the financial crisis, it only took two weeks this time. Fed Chair Jerome Powell then announced an unlimited securities purchase programme that not only increased the prices of directly affected government bonds, corporate bonds and covered bonds, but also caused stock markets to rise. With this "whatever it takes", Powell invited investors to accompany him on a trip that could turn out to be the biggest moral hazard trade of all times. This practically ruled out another plunge in equity prices towards the previous lows, and his announcement that the

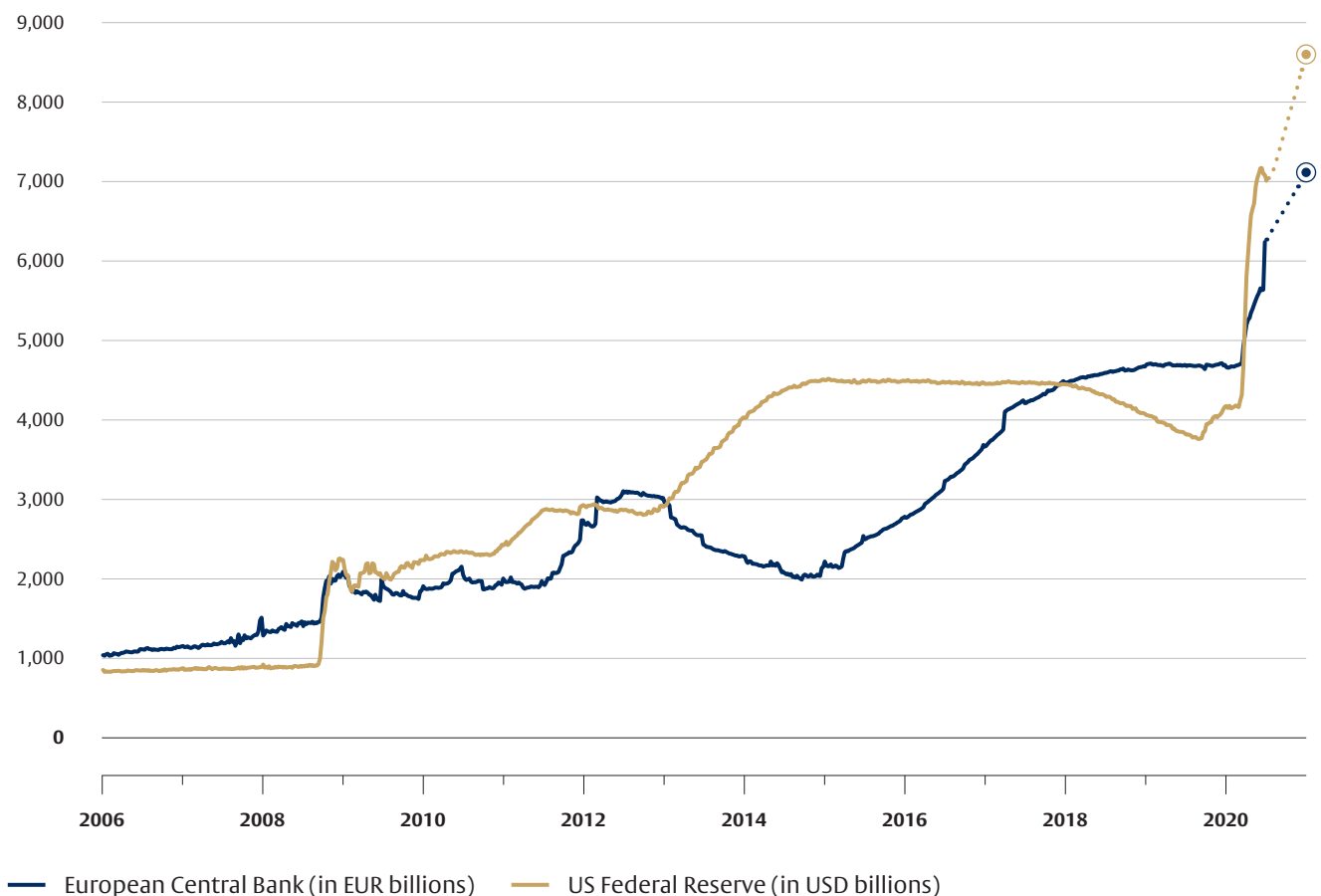
OUTLOOK

US benchmark interest rate would remain at zero to 0.25 per cent until at least the end of 2022 added a “Powell call” to the “Powell put”, thereby increasing the prospects of a further increase in equity prices.

Calculated in US dollars and euros, the increase in central bank balance-sheet assets is around four times as large as in the 2008/09 financial crisis.

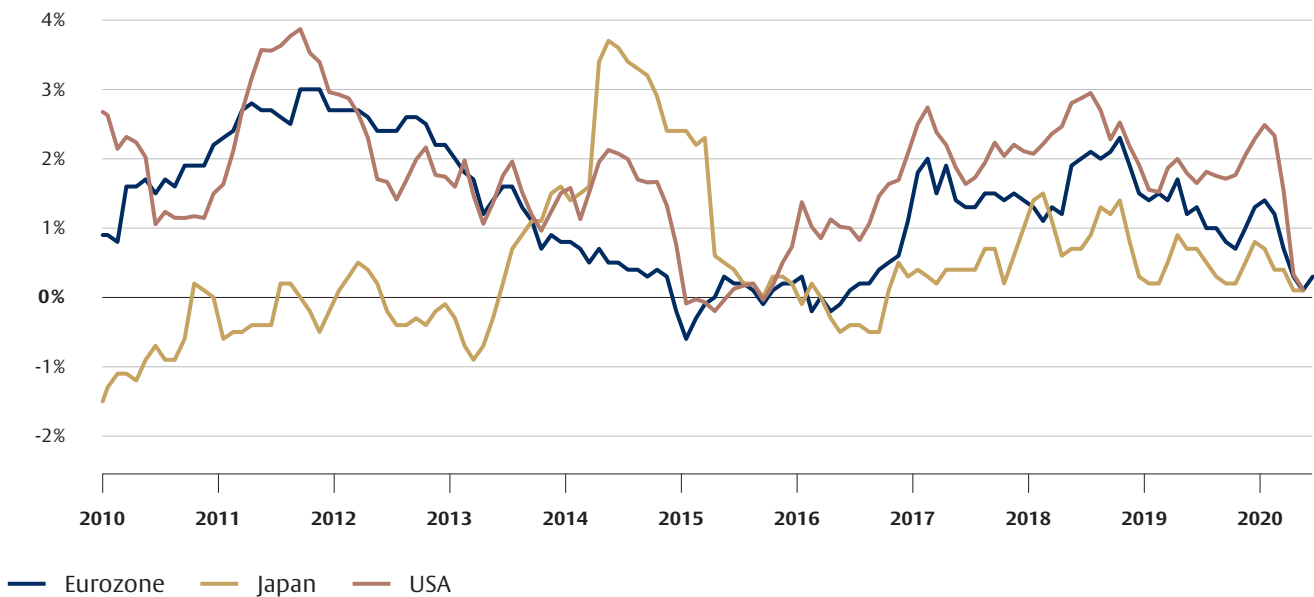
The bond purchases have already created a massive increase in total central bank balance-sheet assets that will continue in coming months. This year alone, total balance-sheet assets will likely more than double from USD 4.2 trillion to an estimated USD 8.6 trillion for the Fed, and increase from EUR 4.7 trillion to around EUR seven trillion for the ECB. Calculated in US dollars and euros, the increase will therefore be around four times as large as in the 2008/09 financial crisis (see Figure 7).

Figure 7 **Exploding central bank balance-sheet assets – Central bank balance-sheet assets at a record level\***



\* Flossbach von Storch projection: This scenario analysis is based on specific assumptions. The future change in total balance sheet assets could differ considerably.

Source: Refinitiv, Flossbach von Storch, data as at 9 July 2020

Figure 8 **Inflation rate at zero** – Inflation rates (consumer prices) since 2010

Source: Refinitiv, Flossbach von Storch, data as at 9 July 2020

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The dramatic increase in national debt ratios makes an exit from ultra-loose monetary policy almost unimaginable.

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An exit from this ultra-loose monetary policy was already practically unimaginable before the Coronavirus crisis. The dramatic increase in national debt ratios makes it even less likely. Without an “all in” of monetary and fiscal policy, the stability of the financial system would be in danger, and this would, in turn, endanger the stability of the value of money. The central banks are facing a dilemma. A sudden withdrawal – i.e. an exit from ultra-loose monetary policy – is no longer possible without ruining the state. ECB Chief Economist Philip Lane naturally sees things differently. On 1 July, he told the Reuters news agency he did not see the ECB as trapped by the high debt levels of some countries and that the ECB’s forward guidance was full of exit strategies. He did not, however, say what this means in detail.

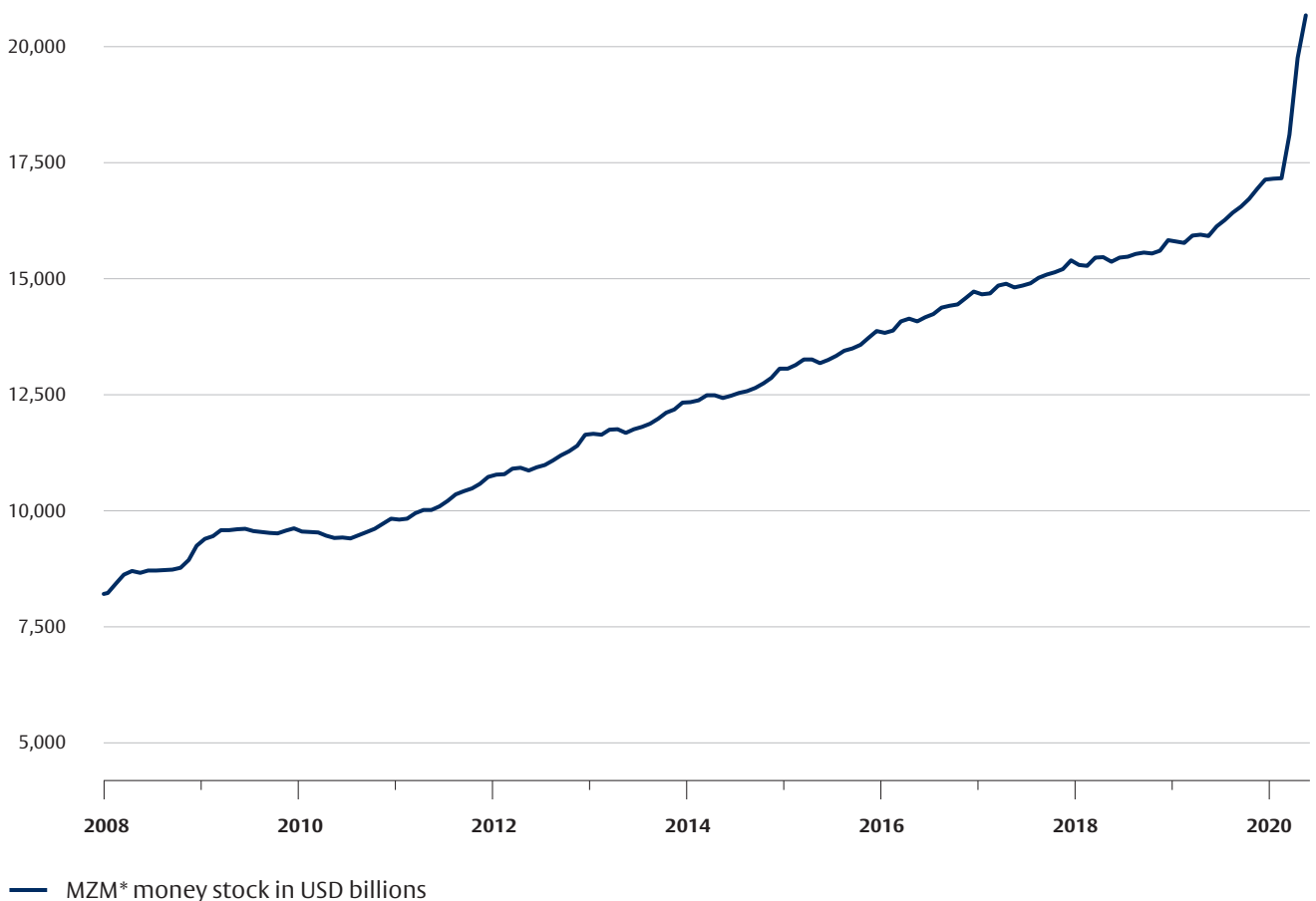
The high level of national debt has therefore also become a problem for central banks and their credibility, which could also lead to a loss of confidence in the monetary system in the long term. Experience has shown, however, that inflation is also needed for this to happen. Once people notice the value of their savings melting away like butter in the sun, their confidence in money also declines. There is, however, currently no sign of inflation. On the contrary, the Coronavirus crisis is putting a damper on inflation for the time being, as shown by the latest figures (see Figure 8).

OUTLOOK

The rapid increase in the stock of money could lead to inflation in the medium term.

One should not, however, completely rule out a return of inflation. Although the pandemic is temporarily reducing demand (less income and fear-driven saving), this is already being fought with massive government aid programmes and loan subsidies, causing the stock of money in circulation to soar. The MZM money stock (in particular cash, account balances, short-term liquid assets) has risen more than 20 per cent in the USA since the beginning of the Coronavirus crisis (see Figure 9). This is creating a surplus supply of money that could raise the price of goods, as previously happened with asset prices, in particular real estate. Inflation is also the only way to reduce the huge mountains of debt, if one ignores the unlikely solution of national bankruptcy.

Figure 9 **The flood of money reaches the economy** – MZM money stock in the USA



\* Money of zero maturity

Source: Refinitiv, Flossbach von Storch, data as at 9 July 2020

Past performance is not a reliable indicator of future performance.

## INVESTMENT STRATEGY

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The stock-market recovery appears almost surreal given the general economic slowdown. Although it is normal for the stock market to move in anticipation of economic changes, there has never been such a major disconnect during a massive economic collapse. After all, many sectors are still at rock bottom and recovery will likely be slow, more and more jobs are being lost and the final wave of insolvencies is still to come.

Growing geopolitical tensions, such as the increasing deterioration of China-USA relations, India's battle against big Chinese technology companies and the escalation of US sanctions policy, which is also causing trouble for large US companies, are also unlikely to generate optimism. The widening spread of the virus in the USA is putting the upswing at risk and worsening the deep divisions in US society. In addition, the outcome and consequences of the upcoming presidential election are almost impossible to predict. There are, therefore, many reasons to be sceptical when looking to the future.

On the other hand, we are in a period of central bank-funded Coronavirus deficit spending that John Maynard Keynes himself could never have imagined, particularly since everything can still be funded at no cost. A worsening of the Coronavirus pandemic will almost inevitably lead to further rescue and economic stimulus packages that can be justified based on the Coronavirus emergency and funded at apparently no cost thanks to a zero interest rate. In countries with negative bond yields, increased debt is even a source of special revenue for the government budget. And since a central bank exit from this low interest-rate policy is no longer possible, little will change in the future.

Considering the current level of interest rates as permanent, however, has major consequences for the value and upside

price potential of equities. The fact that US interest rates, or Treasury yields, have also dropped close to zero plays an important role, since US investors are using the yield on US Treasuries as the relevant risk-free rate for equity valuations. This is not just the case for US equities, but also applies to European and Japanese equities. Since the yield on US Treasuries has fallen much more than the yields in other economic areas, and has reached a historical low of 0.6 per cent, the Coronavirus-driven drop in US yields is having an extremely strong effect on equity valuations – worldwide. The more US investors realise that the low level of interest rates will be permanent, the more equity valuations will rise.

The biggest winners will likely be the shares of companies whose earnings have proven to be comparatively resilient during the crisis and show above-average long-term growth prospects. These Covid-resistant "J"-equities are benefiting greatly from the drop in the level of interest rates. The losers in the crisis, "L"-equities, on the other hand, are not showing any noticeable effects due to the lower level of interest rates. These include companies that are battling with a sustained drop in demand for their products or services (e.g. airline companies), have inadequate digital capabilities (e.g. traditional department stores), or whose business models are being put under pressure by digital alternatives (e.g. the traditional media). Although the drop in interest rates will likely reduce the

future interest burden somewhat for companies in these sectors, this provides little consolation given the erosion of their earnings. “J”-companies, on the other hand, benefit in two ways. First, from increased growth potential due to the Coronavirus and, second, due to a significant increase in their “fair” value, provided the low level of interest rates is considered permanent. **A drop in the interest rate causes present values, i.e. the discounted value of future earnings and, therefore, the value of a company, to rise.**

The discount rate, however, is not just the risk-free rate, but also includes a risk premium that investors reasonably demand for investing in the company. The size of the risk premium mainly depends on the certainty of future earnings and quality of the company’s balance sheet. It is naturally larger for airline companies and banks than for producers of convenience goods. The smaller the risk premium, the greater the share of the discount rate due to the risk-free rate and the more a change in the interest rate affects the value of the company. A sustained drop in interest rates therefore generates above-average increases in the values of companies with comparatively resilient earnings and low risk premiums. This effect is even greater for companies with a high probability of above-average earnings growth, since a low discount rate also increases the present value of earnings growth, as dramatically shown in Table 1.

Three idealised company types are assumed to generate current earnings of 100. The last column shows the effects that decreasing the risk-free rate from 3.5 to 1.5 per cent has on the present value of the future earnings of these companies. The initial interest rate of 3.5 per cent equals the average yield on 10-year US Treasuries in the first half of 2019 (2.5 per cent) plus a safety buffer for a potential yield increase. The current risk-free interest rate of 1.5 per cent equals the current yield level of 0.6 per cent plus a safety buffer.

For the company with cyclical earnings, we have assumed a risk premium of seven per cent, an average earnings growth rate of two per cent in the next 10 years, and a

growth rate of one per cent after that in year 11 and beyond. A decrease in the risk-free rate from 3.5 to 1.5 per cent leads to a theoretical increase of **27.3 per cent** in the value of the company.

The company with resilient earnings is assumed to have a significantly smaller risk premium of three per cent, an expected earnings growth rate of three per cent in the next 10 years, followed by a growth rate of 1.5 per cent. In this case, reducing the risk-free rate leads to a significantly larger increase of **68.3 per cent** in the present value of future earnings, and therefore the value of the company.

Although we also assumed a small risk premium of three per cent for the growth company with resilient earnings, the assumed growth rate of eight per cent over 10 years is considerably higher, followed by a decrease to 2.5 per cent. Reducing the risk-free rate causes the present value to rise by **106.8 per cent** in this case. This ideal combination of resilient earnings and a high potential growth rate leads to a purely theoretical “fair” price-to-earnings (PE) ratio of 83 based on current earnings (see the second-last column of Table 1).

The consumer goods company with slower growth but more stable earnings would have a “fair” PE ratio of 38, while a PE ratio of just 14 times current earnings would be justified for the cyclical company. The astronomical valuations for the companies with resilient earnings, particularly the growth company, should not be misunderstood as our baseline assumption. They only give a rough best-case estimate, and are aimed at illustrating what could happen if the majority of investors accepted the low level of interest rates as permanent and fully included it in their equity valuations.

It is impossible to predict whether this will ever happen. There was a period at the end of the 1960s and beginning of the 1970s when rising national debt and fear of inflation (with the Vietnam War as backdrop) caused investors to look for a safe haven for their assets. Private ownership



Table 1 **Not all boats are lifted by a rising tide** – Valuation effects of falling interest rates

	Risk premium	Growth years 1–10	Growth year 11 and beyond	Risk-free interest rate = 3.5%		Risk-free interest rate = 1.5%		Delta due to reducing the risk-free rate
				Present value	PE ratio	Present value	PE ratio	
<b>Cyclical company</b>	7.0%	2.0%	1.0%	1,139	11.4x	1,449	14.5x	<b>27.3%</b>
<b>Company with resilient stable earnings</b>	3.0%	3.0%	1.5%	2,289	22.9x	3,852	38.5x	<b>68.3%</b>
<b>Growth company with resilient earnings</b>	3.0%	8.0%	2.5%	4,028	40.3x	8,329	83.3x	<b>106.8%</b>

Source: Flossbach von Storch, data as at 9 July 2020

Flossbach von Storch scenario analysis: actual developments may differ from the developments shown.

of gold was not yet permitted in the USA, which meant that shares of large companies with good growth prospects offered the best protection against inflation. Investors were willing to pay up to 80 times annual earnings for shares of Coca-Cola, Procter & Gamble and Johnson & Johnson at that time. The average price-to-earnings ratio for companies like this, also referred to as the “Nifty Fifty”, reached a peak value of 42 – in spite of the fact that the risk-free yield on US Treasuries was seven per cent at the time.

Valuations reached an extremely high level again at the end of the 1990s. This time, however, it was not due to inflationary fears, but instead very optimistic growth expectations based on accelerating globalisation and the boom in technology shares. Many of the high-flyers at the time had never even shown a profit and even a large established company like Microsoft had a valuation of 60 times annual earnings then.

Both of these periods led to exorbitantly high valuations for a comparatively small group of equities. The reasons, however, were very different. In the 1970s, the main reason

was security (flight to real assets), and in the late 1990s it was initially the outlook for rapid long-term economic growth, followed increasingly by the prospect of quick profits through speculation. Nominal interest rates were comparatively high in both periods.

Although the situation is different today, the outcome could be the same. The situation is affected by a combination of two factors, both ironically strengthened by the Coronavirus crisis. One is the low level of interest rates, which should now be assumed to be permanent, and the other is above-average growth prospects for individual sectors and companies. Millions of new securities accounts were opened with brokers in the USA in the first quarter of this year alone. Many investors clearly felt the stock market crash was a favourable time to enter the stock market. The zero rate of interest paid on account balances and money market funds likely made the decision to buy equities easier. The trend was strengthened by the rapid market recovery and spectacular price gains recorded by some equities, and investors became increasingly motivated by speculation during the spring.

Although this also drove up the valuations of the heavyweights in the technology sector, their PE ratios of 25 to 35, with the exception of Amazon, were still considerably lower than the level during the boom phases described above. In contrast, the share prices of cyclical companies are still at rock bottom, which is a reflection of the questionable prospects of some sectors and companies in the post-Coronavirus world and not necessarily an indicator of great catch-up potential.

There is a natural tendency to view the ambivalent performance of stock markets as the beginning of the end. It could, however, also be the end of the beginning if one assumes interest rates will remain low in coming years. In that case, many investors relying on current income and looking for protection against inflation will have to invest in equities. A rising stock market will in turn attract investors that were previously standing on the sidelines and in some cases paying penalty interest on their account balances.

Ironically, a worsening of the Coronavirus crisis would make equities with resilient earnings even more attractive, as it would lead to further economic stimulus programmes and an increase in debt. If the “all in” of monetary and fiscal policy leads to a return of inflation, the flight to real assets would create an additional reason to invest and could even gain the upper hand in the end. Although the combination of high inflation and artificially low interest rates would be a dream scenario for quality equities, the gradual erosion of the value of the savings accounts and bank-account balances held by a large part of the population would leave a bitter taste.

As a liquid real asset, gold also provides appropriate protection against inflation. According to the World Gold Council, gold exchange-traded funds (ETFs) bought 734 tonnes of gold in the first half of the year, more than in the entire previous record year of 2009. This reflects a gradual increase in investor demand that likely has less to do with the Coronavirus crisis itself than its consequences.

The massive increase in national debt, permanent low interest-rate environment and potential return of inflation make gold attractive as a “safe haven” for many investors. It is noteworthy, but not surprising, that the increase in gold ETF holdings was particularly large in the USA. Record low US interest rates and a record high level of national debt motivated both private investors and institutional investors to increase their investments in gold in spite of the recent stock-market rally. For us, gold provides protection against inflation and potential crises in the financial system. Investors should not expect gold to do anything more, but also not anything less, than maintain the real value of assets over the long term. And that is particularly important during periods of zero interest rates.

We have already mentioned in previous quarterly reports that a simple buy-and-hold strategy is no longer a promising way to invest in bonds. It is important to use an opportunistic, flexible approach based strictly on the risk-return ratio of individual securities and markets. The Flossbach von Storch - Bond Opportunities Fund has once again shown that positive returns can still be earned from bond portfolios with such an approach.

## CONCLUSION

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The Coronavirus crisis has changed the world permanently. It accelerated trends that were already in progress, such as digitalisation and increasingly flexible work arrangements. But it also revealed weaknesses in companies and their business models. Some sectors will have to battle with the negative effects for a long time to come, and some companies will fail due to the crisis. Other companies have proven to be Covid-resistant, and some are even enjoying sustained benefits from changes in consumer demand and investment activity caused by the Coronavirus.

Government aid packages and economic stimulus programmes were able to prevent an economic collapse. Countries will take additional measures, if necessary, and will be able to fund them at zero cost given the low level of interest rates. This will, however, rapidly increase national debt to new record levels. Central banks are therefore trapped by their ultra-loose interest-rate policy and doomed to provide the world with cheap money and emergency assistance *ad infinitum*.

More and more investors are recognising that zero interest rates will be permanent and are thinking about possible investment alternatives. The simultaneous “all in” by countries and central banks will likely cause a return of inflation in the medium term and increase the need to protect assets against this risk, which has not been a problem for a long time. In our view, shares of growth companies with resilient earnings are the best asset class for this purpose.



Dr Bert Flossbach

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