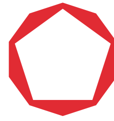
Flossbach von Storch

NEWS

05/2020



INVESTMENT STRATEGY

Exaggerated optimism?

Covid-19 still has the capital markets in its grip. At the start, we too were faced with the question of whether there might be a “script” in relation to the course of the crisis and its long-term effects. Is there a blueprint from the 2008/09 financial crisis that we can use? Unfortunately, it’s not that simple.

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TOBIAS SCHAFFÖNER AND BERT FLOSSBACH

Review – the unexpected rally

Let us first look back at the past few months: in order to better understand how we have reacted in certain phases, we would like to put our implicit investment objective first – to generate adequate returns in good stock-market phases and to limit losses as far as possible in bad phases.

The time since the start of the year can be roughly divided into four phases. **Phase 1** marks the time until 21 February, a Friday. The MSCI World equity index – let us take it as a reference for the entire market at this point – so far gained around seven per cent, despite growing Corona worries; our mixed portfolios were gaining between two and five per cent by this time, which fulfils our claim to perform well in good stock-market phases. On that Friday, the first deaths in Italy were reported. It dawned on us that Covid-19 and its economic repercussions would not be confined to Asia, but could also hit the rest of the world, especially Europe. We then hedged parts of our equity exposure in the funds using futures on the S&P 500 index and the Eurostoxx 50 and tightened the safety-net even further in the weeks that followed. At times, more than half of the equity exposures were hedged.

Phase 2 (24 February - 23 March) can be described as a Corona crash. During this period, the MSCI World, calculated in euros, lost around 30 per cent of its value compared with the beginning of the year (see figure 1). The fund prices lost significantly less over the same period. With the help of the hedges, the sharp setbacks on the capital markets were able to be cushioned relatively well. We also used the setbacks to selectively build up or expand holdings.

Phase 3 began on 23 March, probably one of the most significant days in this crisis, at least in terms of the capital markets. This is the day when the US Federal Reserve (Fed) went "all in" and made an unlimited pledge of support with its new bond-purchase programme (see figures 2 and 3). This pledge marks the start of the stock-market recovery. Such a recovery phase is not uncommon after such severe setbacks, but rather a halfway reliable pattern. During this phase we somewhat reduced our coverage. Phase 3 ended on 15 May.

Phase 4 can be headlined with the term "Rally". The Dax, for example, climbed by around six per cent on May 18, thus again exceeding the 11,000-point mark. The mood "spilled over", the re-opening became a narrative. The most sought-after stocks

Figure 1 **The crisis in focus** – Performance in euros (indexed on 01.01.2015 = 100)

Source: Refinitiv, Flossbach von Storch, data as at 16 June 2020
Past performance is not a reliable indicator of future performance.

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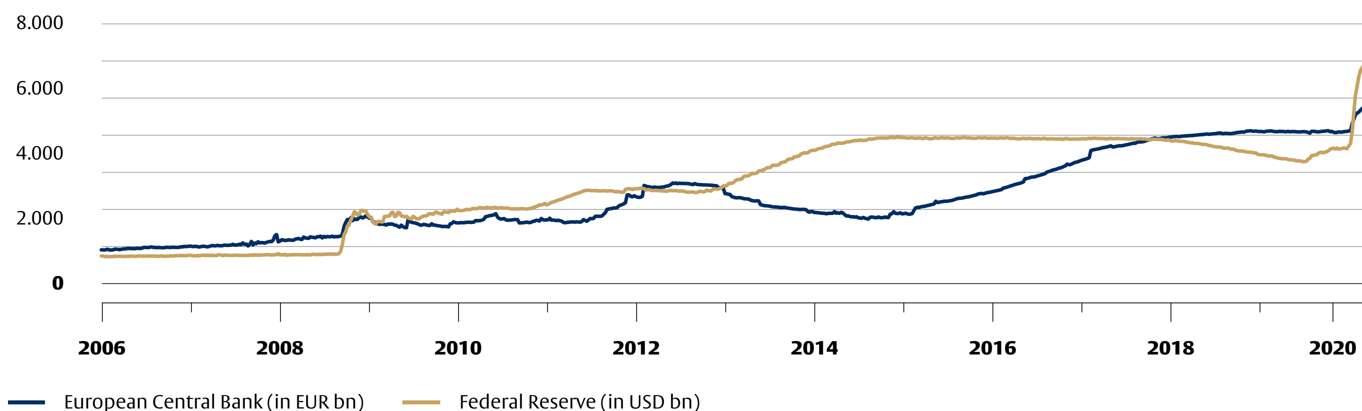
Figure 2 **Record high central bank balance sheets** – Since March the Federal Reserve has increased its US Treasury holdings by USD 1.5 bn



Source: Refinitiv, Flossbach von Storch, data as at 16 June 2020
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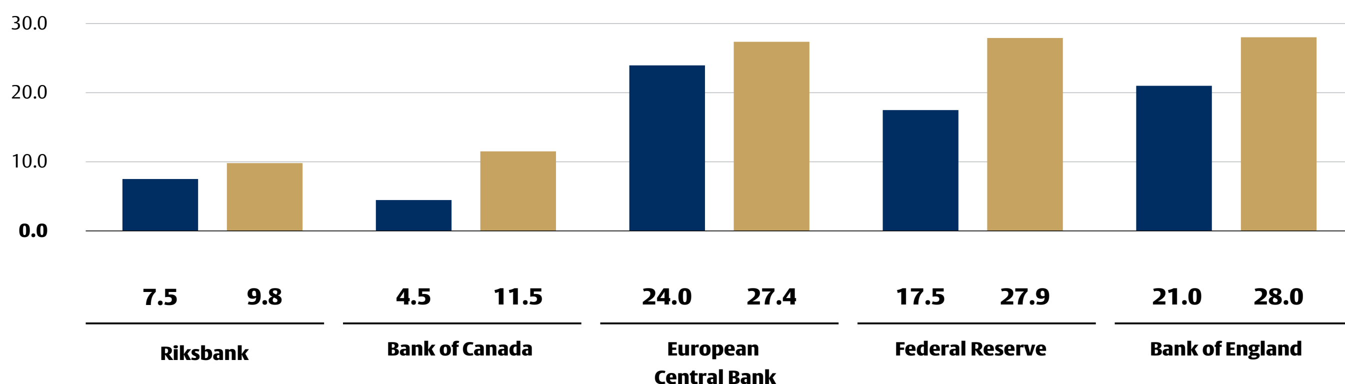
Figure 3 **Central banks – the biggest creditors in history** – Central banks securities holdings as a percentage of GDP (2019)



Securities holdings as at… …31.12.2019 …end of May 2020

Source: Refinitiv, Flossbach von Storch, data as at 16 June 2020

were the cyclical players: banks, airlines and oil companies. We could not imagine such a movement – at that time. It remains to be seen how sustainable it is. Our partial hedging cost us some yield in this phase; in addition, there was headwind from the currency side, as the US dollar weakened. Together, these two factors weighed on performance, at least temporarily.

Current positioning – Focus on quality

We have increased the gross equity exposure in the portfolios, while we have recently reduced the futures further. Most of the investments are in companies from the consumer staples sector, followed by technology stocks. A close look at the portfolio shows that the quality of the companies contained in it is very high. We define quality as a mixture of the growth potential of a company and its "immune system". The latter essentially comprises two components: resilience, i.e. the resilience of earnings, and the quality of the balance sheet. Approximately one third of the companies in which we hold an interest have a net cash position. For comparison: of the 30 Dax members, only two do so. Another 50 per cent or so of "our" companies have very low debt, although this alone is of course not enough:

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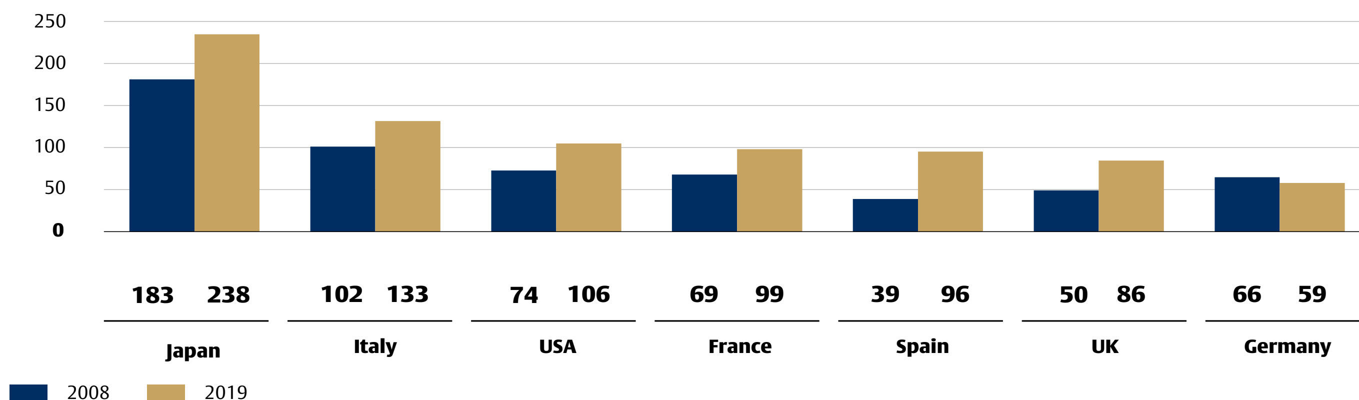
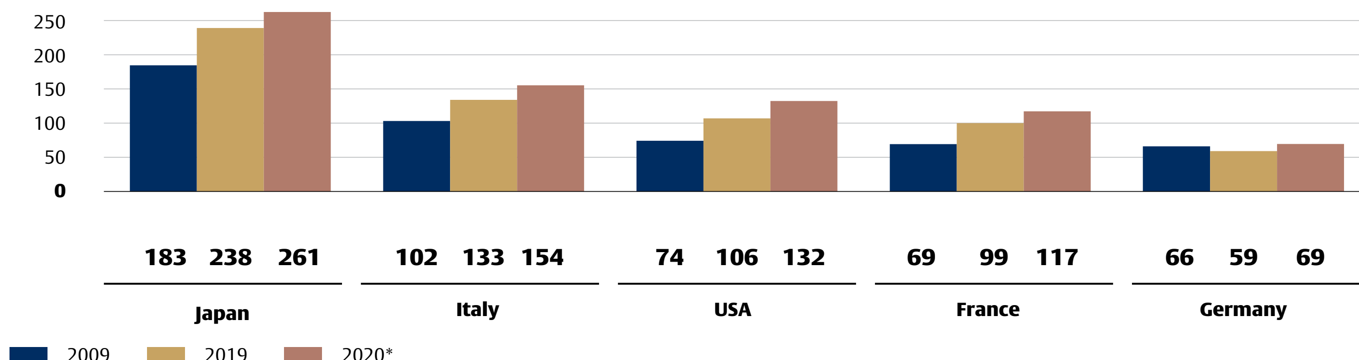
Figure 4 **At first the financial crisis** – General government gross debt as a percentage of GDP



Source: Refinitiv, Flossbach von Storch, data as at 16 June 2020

Figure 5 **Now Covid-19** – General government gross debt as a percentage of GDP



** Projection based on the IMF World Economic Outlook (April database). The deflator is assumed to be zero per cent.*
Source: Refinitiv, Flossbach von Storch, data as at 16 June 2020

if earnings are not resilient enough, even a little debt can be too much.

If we leave the hedging aside, the performance of the equity exposure since the beginning of the year alone has been close to zero, which reflects not least the high quality of the selected securities.

Outlook – The central banks are going "all in"

Even if a "second wave" were to come, it seems unlikely from today's perspective that the measures to be taken then would be on a similar scale as those that have been available so far. In our opinion, massive restrictions, such as a widespread lockdown, would likely no longer be possible, not even in China. The knowledge gained about the virus, the possibilities of infection, and the mortality rate should help to take more targeted action in the future, even if no vaccine has yet been found.

Without wanting to predict the development of the infection rate, we focus on the long-term effects of the pandemic as the basis of our investment strategy: the trend towards more digitisation, the increasing indebtedness of public budgets in particular, and the consolidation of the zero interest-rate environment (see figures 4 and 5). Thanks to the gigantic rescue packages of many states, above all the USA, and the almost unlimited willingness of the central banks to finance them, the danger of a setback in the stock markets to the lows of March seems very unlikely.

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Nevertheless, the recent stock rally has already priced in a rapid return to normality. In view of the great uncertainties about the medium-term effects of the pandemic and increasing tensions between the USA and China, this optimism seems exaggerated – on the one hand. On the other hand, due to the historically low interest-rate level in the USA, there is now a shortage of profitable investments, which has increased the attractiveness of shares and contributed significantly to the disproportionately high price gains on the US stock markets. The fact that the yields of 10-year US Treasuries have fallen below the one per cent mark for the first time should make equities appear even less of an alternative to many US investors. From their point of view, such interest-rate levels seem downright absurd.

Rising share prices combined with falling corporate profits have pushed valuations to unimaginable heights. These would be justified if profits were to recover quickly and interest rates were to remain permanently low. This means that the well-being of the financial markets will depend even more on expansive monetary policy in the future. The massive crisis aid is an early form of helicopter money, distributed by states and (indirectly) financed by central banks.

With this inventory, we continue to focus on tangible assets, such as equities and gold (not physical, see figure 6). As the recovery in the real economy to the status quo ante is unlikely to occur as quickly as currently hoped, we have still hedged part of our equity exposure. We focus on companies with high-earnings continuity, solid balance sheets and long-term growth potential. With this focus on the quality of the companies in which we invest, the portfolios are also "crisis-proof" regardless of their equity exposure.

Figure 6 **Safe-haven currency** – Gold price vs. MSCI World Index incl. net dividends in EUR (indexed to 01.01.2018)

Source: Refinitiv, Flossbach von Storch, data as at 16 June 2020
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Publisher Flossbach von Storch Invest S.A.
6, Avenue Marie-Thérèse, 2132 Luxembourg, Luxembourg
Telephone +352 264 584 22, Fax +352 264 584 23
info@fvsinvest.lu

Executive Board Karl Kempen, Markus Müller, Christian Schlosser
VAT Number LU 25691460
Commercial register Luxembourg No B 171513
Competent supervisory authority
Commission de Surveillance du Secteur Financier (CSSF), Luxembourg
283, Route d'Arlon, 2991 Luxembourg, Luxembourg

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