BPM Berlin Portfolio Management

Published as a guest comment (24 February 2020) on

DAS KNOW-HOW-MAGAZIN ZUR KAPITALANLAGE
INVESTMENT

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Stock markets are decoupling from the real economy

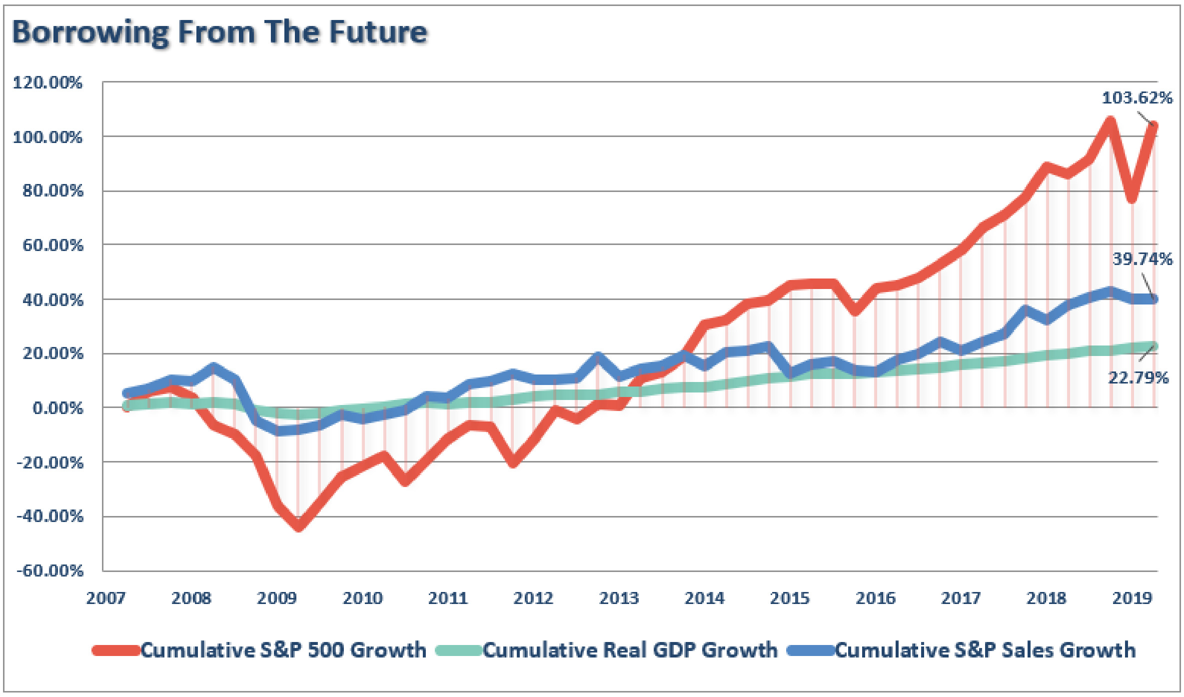
Share prices and basic economic figures have moved far away from each other. In the mature phase of an economic cycle this creates a particularly explosive situation for asset investments, says Uwe Günther of BPM – Berlin Portfolio Management.

The well-known analogy of the man with his dog in the park originates from past master of the stock markets André Kostolany: The master (= the economy) strolls to his destination at a leisurely pace. The dog (= the stock market) sometimes runs ahead and sometimes back, but they both arrive at the exit to the park together. Here Kostolany very accurately describes phases when the stock markets over- and under-react in comparison to the actual development of the economy. And it still holds true today because things are not "completely different" this time either.

If you looked at the growth measured in dollars of the American benchmark S&P 500 index (not the growth in value) since 2007 and set against it the actual growth of American gross domestic product (GDP), it would be enough to make some market watchers keel over – some because they'd be mad they didn't buy the index years ago, and others because they'd run out of reasons why the stock market index has decoupled from real economic growth in a historically almost unprecedented way and continues to do so.

When making this comparison, it's worth digging a little deeper because the relationship between the development of the stock markets on the one hand and turnovers, growth in profits, book values, sales proceeds, profits and debt and other company valuation figures on the other has often reached extreme, and in part historically unique valuation levels.

S&P 500 versus real GDP growth vs. sales growth



Source: RIA Advisors

But indices in general, and the S&P 500 in particular in this case, are not a good yardstick for measuring the dynamics of economies. According to easily understandable calculations made by several investment banks, FAANG shares as they are known (Facebook, Amazon, Apple, Netflix, Alphabet - previously Google), plus a few others like Microsoft and Tesla, are responsible for a predominant amount of the growth of shares by themselves.

If these are deducted, a different and to some degree quite gloomy picture reveals itself. Even *with* FAANG and friends, from March 2000 till today the S&P 500 has only brought the modest return of 5.6 per cent annually. That may come as a surprise to the odd stock market optimist or two. And caution is advised because in order to continue this trend in value (some well-known colleagues are even much more optimistic), conditions would have to exist which should make even the greatest of optimists have doubts.

Looking in the rear-view mirror is dangerous

The strategy of just betting on past winners and their trends could prove to be a serious mistake in the near future. After all, it was particularly share repurchases, the seemingly endless availability of central bank liquidity, hedge fund and central bank purchases as well as a skewed interests market which caused rates to sky rocket ever higher. The current positive stock market dynamics (and future anticipated ones) can hardly be derived from turnover and earnings figures alone or from the future company growth that can actually be expected.

Even the reason of endlessly low interest rates, often eagerly touted by many colleagues, could easily turn out to be wrong. The central banks themselves typically contest their responsibility for the low interest rates. If this is the case, maybe the current capital market interest rates are actually giving us a foretaste of the extremely low economic growth to come for which sooner or later the market à la Kostolany will set the prices. That would make a fairy tale out of any future anticipated profits inherent in the stock market rates.

But maybe there's another argument for the extreme company valuations and stock market rates that hasn't been adequately considered up till now. It's precisely the companies just named that have been piling up one kind of raw material in their warehouses for quite a while which is going to become more and more significant in the future: data. Yet it still remains moot to what extent this treasure of the future will be able to be transformed into hard cash (including from the political and regulatory standpoint).

The only thing that's certain is the unenlightening fact that hardly anyone will want to leave the party (or the herd of consultants) early so as not to end up as a loser, even though they're perfectly familiar with the facts of history and simple mathematical relationships. The stock market is still probably the only market place where people particularly like buying at maximum prices. Penny-pinching is reserved for the supermarket.

Against this background, those investing in standard index ETFs in particular should question the dependence of their investments on a few promoted values. Advocates of the marketing theory which claims that despite hefty setbacks investing in shares "is always successful, if you only wait long enough" could try taking a sharp pencil and calculating the ratio between the time left till their retirement and the average rate of return they'll need.

And are shares really always worth investing in? Or does the sale price in relation to anticipated future company profit possibly play a more important role than many believe? This divide can of course open up even more widely. The first signs of a giant breakup can already be seen today.
Yet whoever believes in the old rule of business which says that future profit is made by buying at a good price should by all means look and act accordingly. What was it Kostolany said again? *"Whoever doesn't believe in miracles on the stock exchange is a realist."*

All the best and good luck in all your present and future endeavours!

Uwe Guenther and the BPM Team

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