BPM Berlin Portfolio Management

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Waiting for the Final Panic

There are alternatives to shares

A guest contribution from Uwe Günther

The German DAX and many other leading indices have fallen by 25% percent and more already since April 2015. But there isn't a bargain just yet. Until then, investors should keep their powder dry.

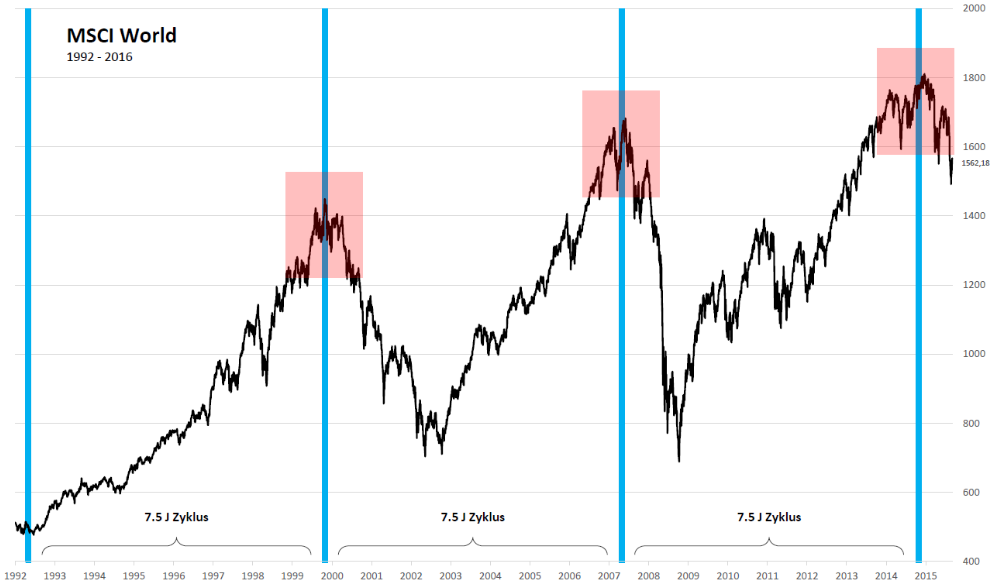
The sales teams of the large asset managers and banks like to call shares 'without any alternative'. But why? Is there an unwillingness to accept that the unprecedented flood of paper money by the federal banks greatly distorts not just bond returns but also share prices?

Given the less than 0.3 percent interest currently earned on federal bonds, such a line of argument at first appears logical. For instance German DAX companies provide average return dividends of close to three percent. But profit distributions are only really helpful if the corresponding share prices have at least a stable development. But this has no longer been the case in the last three quarters of a year.

When comparing shares and bonds, it is often overlooked that not only bond returns but also inflation are extremely low. Against this background, federal bonds as a 'parking space' for liquidity at least ensure that assets are protected. 10-year US treasury bonds currently offer returns of close to two percent. Given the extremely low devaluation of money, real interest is only slightly below that of previous years. Compared to this, many global companies have suffered a loss of their value since the high in April 2015 of around 20-40 percent. Looking at it this way, the alleged lack of an alternative for shares no longer applies. And the long-term correctness of the statement is instead replaced by a short-term rallying call.

Substance isn't everything

In arguments in favour of shares, it is often emphasized that these are 'substance values'. But that's only partially true: A share company is financed not just by its equity, i.e. its actual substance, but also by third-party capital, i.e. debts and liabilities. This can quickly turn the frequently cited lack of an alternative into its opposite - whenever a slow economy and slack sales mean that companies must use both their profits and their substance to pay for their liabilities. Recently, this observably occurred for numerous energy companies and banks, but also several manufacturing companies. Once the third-party funding, i.e. debt, used no longer results in positive returns for companies, the market starts to distinguish between the unproductive liabilities and the substance value of such shares. The result is - as could be seen in the past few months - that share prices fall. The global equity Index MSCI sent already clear warning signs since mid 2014:



Many professionals have already moved over to the selling side. In recent weeks, banks such as JP Morgan, UBS, Citibank, Royal Bank of Scotland or Deutsche Bank have provided their institutional (less so their private!!!) clients with more than clear analyses and warnings. "Buy on dips" is out – “sell on tops” is in. That's because there might be fewer tops on the stock markets in the current cycle in the next few weeks and months.

The charts are beginning to look strikingly similar to those in 1999/2000 and 2007/2008. After tops had been created at the time, the most important indices then fell by more than 50 percent in an accelerated healing process. In that sense, the stock markets still have some way to go even with the painful corrections that have occurred so far. The "God-like trust" in the almighty power of the federal banks learned in the last six years then quickly turns into despair and panic, as it usually does at the end of long cycles.

If you panic - panic first!

The good news is: The major market players want to reduce their risk tidily. But private investors should not be tempted now to take over these risks. At the moment, many stock markets still consist of too much "hot credit air". And until this can escape and dividends are again worth their price, powder should be kept safe and dry. For the markets start to reach bargain levels (like recently visible in the precious metal, oil and energy sector…), the usual capitulation among broad circles of investors is still needed.

But until this spreads, it is better to gain a defensive or well-protected position instead of needing to panic and flee through the emergency exit later on. In the meantime, cash and highly rated bonds are a serious alternative to shares after all. Accepting that shares can be a long-term investment does not mean that we need to join the party at all major market adjustments. And once the market has corrected itself, we can happily take a slice of the substance values again.

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