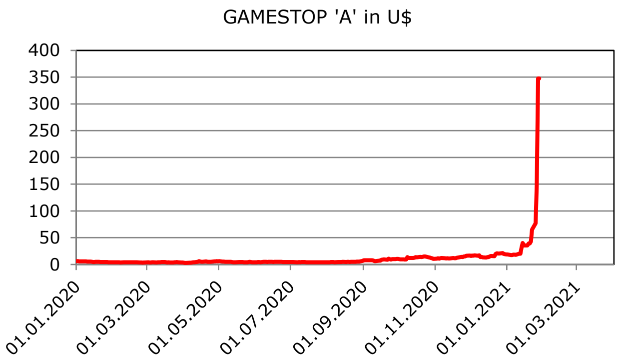
ECONOMIC SITUATION AND STRATEGY January 29, 2021

Stock markets: GameStop or GameOver?

The stock markets have started the new year with a bang. Germany's blue chip DAX index surpassed 14,000 points in early January, and the major US indices have recently reached all-time highs as well. That is not very surprising considering the global interest rate lull and escalating investment crisis. In view of the continuing stock market party despite the pandemic, however, there is nevertheless a good number of investors who have a queasy feeling when they look at the stock markets. Are the high prices really justified or is a large speculative bubble forming that will inevitably burst?

Global stock markets have already hit some snags in the past few days. The DAX has declined to about 13,300 points, and most European stock indices show negative price performance since the beginning of the year. Things look better on the US markets and in emerging countries, but prices have also come somewhat under pressure there lately. Is this the beginning of an extensive, sustained valuation correction?

A striking example of a very recent price bubble has arisen in the last few days from the stock of GameStop, a US computer game retailer with sales of USD 6.5 billion in 2019. As it had already in 2018, the company made a loss in 2019 (USD 464 million after USD 795 million). Like many other retailers, the company is suffering from the continuing shift of shopping to online platforms, among other things. Because of its considerable business difficulties, the company has drawn to the attention of short sellers, investors who bet on falling stock prices. Some US hedge funds have accumulated short positions in the past months because they expect that they will be able to cover them with shares purchased at lower prices later.



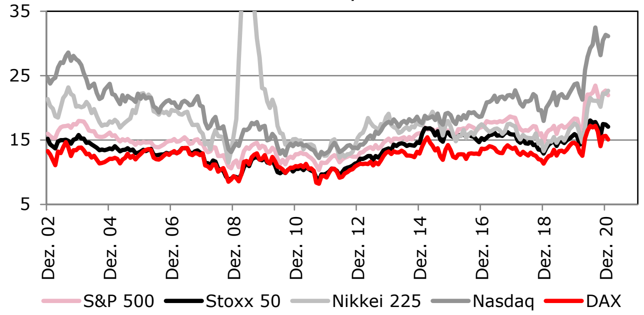
However, the hedge funds did not anticipate so many private investors who joined forces in Reddit's forum WallStreetBets to buy GameStop stock and drive its price to ever-greater heights. The use of options made this possible, putting "small" private investors in a position to leverage and thus significantly enlarge their wager. New trading platforms like Robinhood contributed to this by enabling their mostly young clients to trade options free of charge. Such financial instruments allow one almost miraculously to achieve a huge effect with an originally small investment, and that is amplified by short sellers having to cover positions by likewise buying the stock. Consequently, the price of GameStop stock has shot up rapidly since the beginning of the year, from USD 18.84 to USD 347.51, a gain of almost 1,800%.

While those who have bought GameStop stock in recent days and weeks celebrate their impressive (book) gains, fundamentally oriented investors can only shake their heads. In view of an expected loss of USD 0.17 per share this year, no price-earnings (P/E) ratio for the company can be calculated. If we take earnings expectations for 2022 of USD 1.35 as realistic (source: FactSet), we arrive at a P/E of 257. For these reasons, we remind all who have speculated on falling prices of the quote attributed to John Maynard Keynes that "the market can remain irrational longer than you can remain solvent." Much more bubble than what we are seeing in this stock now is not likely. But at some point – probably in the near future – the air will go out when investors decide to cash in their book gains, and then demand for the stock will no longer be strong enough to keep prices at the current level. From an investor's standpoint, it could then make sense to rename the stock from "GameStop" to "GameOver."

There are yet other indications demonstrating that investors are too euphoric about some stocks and that greed is sometimes bigger than sanity. This is shown by the example of those who buy shares of rather unsuccessful companies with ticker symbols accidentally similar to those of successful companies (Zoom Technologies versus Zoom Video Communications or biotechnology firm Signal Advance, which has nothing to do with Messenger Signal or, most recently, Australian nickel producer GME Resources, which has the same combination of letters (GME) on the Australian stock exchange as GameStop has in New York). Nevertheless, we would not see global stock markets as of now in the acute stage of a beginning bubble. However, the fact remains that stocks have become very expensive in the past few years if we look at their absolute valuation multiples.

For example, the DAX has a P/E ratio of 15 based on earnings expected in the next 12 months, which is a good 20% more expensive than the average since 2003. The Stoxx 50 (P/E of 17) and Japan's Nikkei index (P/E of 23) are now valued about 25% higher, while the markup for the S&P 500 comes to 44% (P/E of 22), and for the Nasdaq 100 to 60% (P/E of 31).

P/E since the year 2003

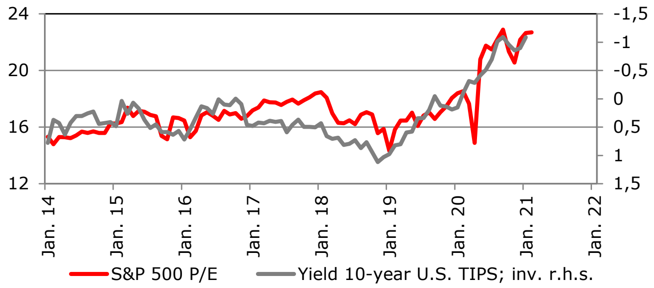


Source: Factset

It puts the picture in perspective, however, to include interest rate development in our analysis as an important explanatory factor for stock valuation. The levels of government and corporate bond yields have fallen almost continuously in the past years due to accommodative central bank monetary policy. Investors who divide their wealth in liquid asset classes like stocks and bonds have benefited from price advances in the past years despite ever-lower bond coupons. Consequently, it has paid off to put part of their wealth in fixed-income securities. However, there is good reason to believe that government bond yields will not decline further this year, but will rather tend to move sideways. Further price advances are thus unlikely, and the current interest payments are uninteresting to most investors. The prospects are somewhat better for corporate bonds, even though the likely value gains should be modest. For many investors, strategies based on bonds have therefore become uninteresting, and they must rely on a higher stock ratio to achieve their return objectives. That is exactly what the acronym TINA expresses: "there is no alternative."

This situation is illustrated by a comparison of stock P/E ratios with "bond P/E ratios," the latter being calculated from the reciprocal of the current bond yield. For the US stock market, the yield on Treasury inflation-protected securities (TIPS) has explained the P/E of stocks even somewhat better than the yield on "normal" Treasuries in the past years. On this basis, we may conclude that the valuation of the S&P 500, which is very high by international comparison, is still within the realm of what interest rates can explain. It is equally true of technology stocks that interest rates are also the key explanatory factor for their optically high valuation. Many tech firms will only make a large part of their earnings in the future, and those earnings viewed from the present perspective are more valuable, the lower the discounting factor is.

S&P 500: Price earnings ratio for the coming 12 month and 10-year TIPS



Source: Refinitiv Datastream

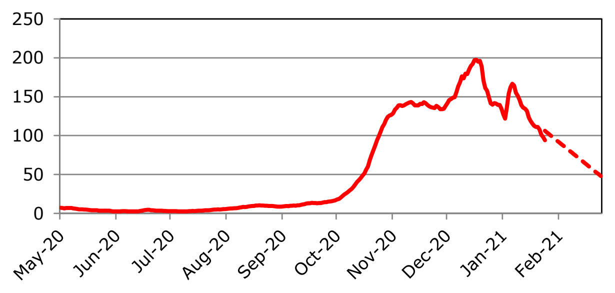
A valuation bubble would only arise if interest rates or government bond yields should increase significantly while the stock P/E ratio remained unchanged. But that is not likely to happen considering that the European Central Bank at its meeting last week and the US Federal Reserve last Wednesday have both clearly stated their commitment to keeping monetary policy accommodative for a very long time. However, if yields should remain at their current level, that would also mean that stocks would not get any more tailwind from even higher valuation ratios. A positive stock market trend such as we expect for this year would then be based solely on higher corporate earnings.

We also regard exactly that as a very plausible assumption. The reporting season for the fourth quarter of 2020 shows that earnings have developed more positively than corporate analysts had forecast. Of the roughly one-third out of all companies in the United States that have already reported quarterly figures, about 90% and 80% have beaten earnings and sales expectations, respectively. This is likely to cause analysts to raise earnings forecasts for the coming quarters. The result will be either lower valuations on unchanged stock prices or unchanged valuations at higher stock prices.

We therefore do not regard the latest market gyrations as the beginning of a sustained valuation correction. As often in recent quarters, some investors appear to be acting according to the motto "sell on good news" during the current reporting season, giving priority to securing their price gains for now. But as long as interest rates do not rise substantially and the scenario of an economic recovery with better corporate earnings is still intact, people will soon have to face the question of how to invest the realized funds. Weaker prices thus present an opportunity to accumulate shares of "good" companies whose business models exhibit long-term success.

As usual, European stocks have corrected more sharply than their US counterparts in recent days, despite their cheaper valuation. This is also a sign that the latest price declines do not necessarily have anything to do with worries of bursting bubbles. Instead, concerns about the economic impact of covid variants and news regarding vaccine availability are likely to play a dominant role in Europe and particularly in Germany. Some forecasts of German economic growth in 2021 have been reduced significantly this week, for example, by the International Monetary Fund (from 4.2% to 3.5%) and by the German government (from 4.4% to 3.0%). However, we believe these adjustments might prove to be premature, since the past year showed how quickly the economy recovers when restrictions are eased or lifted. Hope in this regard may be taken from the significant decline of the Robert Koch Institute's measure of national 7-day incidence, which is below 100 for the first time since the end of October. If the trend observed since late December continues, 7-day incidence might fall below 50 by the end of February at the last. We truly hope that it does.

Germany: Corona 7-day incidence



Source: Robert-Koch-Institut

Market Data Overview

Stock marktes	As of 29.01.2021 16:19	Change versus 22.01.2021 -1 week	28.12.2020 -1 month	28.10.2020 -3 months	28.01.2020 -1 year	31.12.2020 YTD
Dow Jones	30384	-2,0%	-0,1%	14,6%	5,8%	-0,7%
S&P 500	3762	-2,1%	0,7%	15,0%	14,8%	0,2%
Nasdaq	13247	-2,2%	2,7%	20,4%	42,9%	2,8%
DAX	13554	-2,3%	-1,7%	17,2%	1,7%	-1,2%
MDAX	31228	-1,3%	1,9%	20,6%	10,1%	1,4%
TecDAX	3387	0,5%	5,4%	19,7%	7,5%	5,4%
EuroStoxx 50	3508	-2,6%	-1,9%	18,4%	-5,7%	-1,3%
Stoxx 50	3095	-2,9%	-0,1%	14,4%	-9,5%	-0,4%
SMI (Swiss Market Index)	10621	-2,8%	0,2%	10,4%	-1,5%	-0,8%
Nikkei 225	27663	-3,4%	3,0%	18,1%	19,2%	0,8%
Brasilien BOVESPA	117471	0,1%	-1,4%	23,2%	0,9%	-1,3%
Russland RTS	1371	-3,4%	-1,5%	27,1%	-12,8%	-1,2%
Indien BSE 30	46286	-5,3%	-2,3%	15,9%	13,0%	-3,1%
China Shanghai Composite	3483	-3,4%	2,5%	6,5%	17,0%	0,3%
MSCI Welt (in €)	2711	-1,5%	1,9%	13,5%	3,6%	1,9%
MSCI Emerging Markets (in €)	1351	-2,9%	8,5%	16,4%	11,1%	5,7%
Bond markets						
Bund-Future	177,77	61	38	170	409	13
Bobl-Future	135,24	11	14	-58	71	6
Schatz-Future	112,32	5	6	-14	32	4
3 Monats Euribor	-0,54	2	1	1	-14	4
3M Euribor Future, Dec 2017	-0,59	-4	-5	-7	-17	0
3 Monats $ Libor	0,21	-1	-4	-1	-156	-3
Fed Funds Future, Dec 2017	0,08	1	0	0	-119	0
10 year US Treasuries	1,09	0	15	31	-55	17
10 year Bunds	-0,51	3	5	12	-10	6
10 year JGB	0,06	3	4	5	10	4
10 year Swiss Government	-0,44	0	3	10	30	5
US Treas 10Y Performance	706,95	0,3%	-1,1%	-2,2%	8,4%	-1,3%
Bund 10Y Performance	684,16	0,3%	0,0%	-0,7%	1,7%	-0,1%
REX Performance Index	498,68	0,1%	0,0%	-0,5%	0,4%	-0,1%
US mortgage rate	0,00	0	0	0	0	0
IBOXX AA, €	0,06	1	2	0	-10	4
IBOXX BBB, €	0,56	3	-1	-22	-20	1
ML US High Yield	4,87	-1	-13	-112	-120	-11
Convertible Bonds, Exane 25	8286	0,0%	-0,4%	6,8%	6,8%	-0,5%
Commodities						
MG Base Metal Index	356,24	-1,0%	-0,9%	12,5%	25,5%	0,4%
Crude oil Brent	56,05	0,9%	9,1%	42,9%	-6,5%	8,0%
Gold	1861,75	0,4%	-1,1%	-1,1%	18,5%	-1,9%
Silver	26,21	2,8%	1,6%	11,5%	49,4%	-0,6%
Aluminium	1983,35	-0,7%	-2,1%	10,4%	14,1%	0,5%
Copper	7879,65	-1,4%	1,4%	17,1%	38,8%	1,7%
Iron ore	168,63	-0,7%	8,5%	40,0%	80,2%	8,2%
Freight rates Baltic Dry Index	1470	-18,8%	7,6%	6,2%	172,7%	7,6%
Currencies						
EUR/ USD	1,2140	-0,1%	-0,6%	3,5%	10,3%	-1,1%
EUR/ GBP	0,8850	-0,6%	-2,6%	-2,1%	4,4%	-1,1%
EUR/ JPY	127,13	0,7%	0,5%	3,9%	5,9%	0,5%
EUR/ CHF	1,0792	0,2%	-0,6%	0,9%	0,8%	-0,1%
USD/ CNY	6,4223	-0,9%	-1,8%	-4,6%	-7,7%	-1,6%
USD/ JPY	104,23	0,4%	0,4%	-0,1%	-4,5%	0,9%
USD/ GBP	0,73	-0,3%	-2,0%	-5,2%	-5,3%	-0,3%

Source: Refinitiv Datastream

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