CONCEPT
VERMÖGENSMANAGEMENT

Fragile!

Annual Report
2016

FRAGILE!

Should stock market assessments and market commentaries increasingly be consigned to the category of "prosaic entertainment"? If so, what is the reason for this? Firstly, the world markets have been circling around the same unresolved challenges for years. The nuts and bolts currently being tinkered with are much too small to have a significant effect. And, secondly, we remain in "uncharted waters": where policies and central banks are currently heading, nobody has ever been before. The crew has, at best, a vague idea of the surroundings, and no one has any previous practical experience. Moreover, it seems that the usual market physics have been put out of action – a lot of money is driving our ship forwards using the wind of a fan mounted on the deck. We know that this should not really be possible, but it seems to be working. Last but not least, forecasts based on pure factual knowledge are losing credibility. Because, using the facts, we would already have had to paint a very gloomy picture for a very long time, thereby joining the by now hoarse prophets of doom, and started hoarding gold.

Our status assessment at the start of the year is being provided against the backdrop of several surprising twists that shaped the previous year. Right at the beginning of 2016, sudden and massive worries about a significant slowdown in Chinese growth and devaluations of the Renminbi kept the markets on edge; the volatility increased significantly. As the year went on, the British referendum regarding whether to remain in or leave the EU resulted in uncertainty. The outcome was tight, and quite a surprise for the pollsters, as 51% voted to leave. But the irritation on the markets only lasted for a week, and stock prices then rose significantly, in particular in Great Britain which was the most directly affected. As soon as the rest of the markets had recovered from Europe's fright, the next major event of the year, the presidential election in the USA, cast a paralysing shadow over the stock exchanges. In the end, the scenario that had hardly seemed possible there came true. However, already on the day after the election, the initial excitement in the markets gave way to more sober contemplation. And the analysis shows that, irrespective of the expected (foreign) policy and social changes, something close to the implementation of Trump's current priority plans would definitely have a predominantly positive effect on companies in the USA. The stock markets react emotionally and pragmatically at the same time; they are frightened by the unexpected events, but immediately dissect the consequences and deal with the resulting expectations. And these are initially assessed as being positive for the economy and for the stock markets. Potential problem areas, such as the president's protectionist warning shots, are dismissed as being likely to decrease in relevance.

The stock markets react emotionally and pragmatically at the same time

AGAINST THE ESTABLISHMENT

The American election, the British exit, and the cancellation of the planned Italian constitutional reform in December demonstrate one thing very clearly: people have the feeling that things are out of control. Many want change and therefore turn away from the political establishment, from a policy of muddling through based on the lowest common denominator. Low-income families feel increasingly excluded, unseen and potentially threatened by strangers. Real policy seems to be less and less intelligible and communicable. This observation applies to the USA, the United Kingdom, Italy, and also to Japan, the EU, and not least to Germany. Who can explain the sense or even the advantage of negative interest rates? Who knows where new jobs can be created, replacing the ones wiped out by globalisation and technological

People have the feeling that things are out of control.

development. Who gives people a coherent impression of a coordinated refugee policy in the EU? Who is still able to make the peace-inspiring vision of Europe understandable and also tangible? The answers to such questions are provided, at best, based on an intelligent horizon, but for many people bear less and less relation to the realities of life .

Strategies that were previously seen as having "no alternative" are faced with genuine alternatives.

In previous reports, we have often criticised the lack of purposeful and direction-oriented policies throughout the industrialised world. And now, strategies that were previously seen as having "no alternative" are faced with genuine alternatives in the form of persons, organisations and parties. These speak in the language of the affected people, offer simple solutions to complex challenges, and now constitute more than just a politically incorrect way of thinking. But the fact is that the forces that are putting pressure on the establishment are (at best) able to diagnose the disease, but are not in a position to be able to formulate methods of treatment. An unpopular President Trump in America, whom the designated German president refused to congratulate, may still turn out to be one of the more moderate heads of government among Western countries following the upcoming elections this year in France, the Netherlands, Germany and probably Italy. New populist parties are gaining considerable shares of the vote everywhere, right through to the possibility of becoming part of government. If the political course in America seems unpredictable for us at the moment, the possibilities of such developments in Europe must, as of now, be taken seriously as well. In this context, the greatest risk is the consequences of a failing Italy, which has not been able to overcome the crisis at all. The defeated referendum on Italian constitutional reform has given Europe a new potential breaking point on the other side of the Brenner Pass. A change of government is brewing in the second most heavily indebted member of the EU (after Greece), which also has the most bad loans. The Five Star movement is not exactly afraid of criticising the system, and has gained considerable popularity as a result. Without offering any real proposals for solutions, it captured 25% of the votes in the last parliamentary election, has provided the Mayor of Rome since June, and recently proposed the holding of an EU referendum. And what would happen if Italy was to decide just as "unexpectedly" as the UK? It would constitute a maximum credible accident (MCA) without an emergency plan.

INTERDEPENDENCY BETWEEN POLITICS ...

It seems as if an outline of the world which was previously clear to a certain extent appears to be breaking up.

So what does all this have to do with our status assessment and why do political considerations form such a large part of our explanations? With regard to the economy, world politics and global society, it seems as if an outline of the world which was previously clear to a certain extent appears to be breaking up with tectonic shifts of power, interests and ethnic groups. The post-war period was marked by very clear points of orientation: with the two remaining superpowers maintaining a "balance of terror", reconstruction and the associated economic miracle took place between these opposing poles and the successful formation of a European Union came about. In 1991, after the disappearance of East Germany, the Soviet Union also broke up as the result of a purely socialist approach, and America was the victor of the Cold War. A "new world order" emerged, which seemed capable of breaking the old friend-foe approach. Globalisation and the Internet became the dominant impetus for technical innovation and the flourishing of world trade. At the same time, however, intensified international competition and accelerated rationalisation laid the foundations for the challenges we face today, and a threat to the new order emerged in the form of Al-Qaeda.

Economic and political disruptions often produce time-delayed consequences, which sometimes only come to light a generation later. For example, globalisation and rationalisation seem to have left behind people who feel excluded, who are struggling with falls in real income and who no longer understand the decisions of the elite. The birth defects of the euro have stifled the promising beginnings of European integration, triggered a financial crisis that has not yet been overcome, and put Europe back to square one in terms of its existential issues. The geostrategic policy of the West in the Middle East has failed; the power vacuum there is a perfect breeding ground for anarchy, religious terrorism and genocide, thereby forcing millions of people to flee in the direction of the welfare states.

The pressure is rising ...

The feeling that the pressure is rising cannot simply be dismissed. When and where the pressure may escape cannot be predicted. The energy that is liberated as a result could lead to even greater shifts in power. It is no longer a matter of smaller or larger alliances and coalitions, and no longer about centre-left or centre-right. National and international conglomerates that are incompatible with traditional political regulations could arise, with the result being a blurring of outlines and breaking of traditions, all the way through to the creation of societal divisions. In concrete terms and regarding the immediate future, the following questions are key: How far will the "new America" go in terms of the balancing act between alienating China and pursuing fraternal cooperation with Russia? In which direction is the proxy-war in Syria drifting and is there an imminent threat of the civil war spilling over into the NATO partner Turkey? Can Europe achieve a coordinated, consistent and sustainable refugee policy? With probable new elections in Italy, will the euro's structural problems bubble up to the surface again? Is the problem of global over-indebtedness convincingly solved, or has regulation via the markets completely taken over and resulted in a major capitulation of the central banks?

... AND STOCK MARKETS

Stock markets do not operate in a parallel universe that is confined to economic issues.

There are countless challenges facing the world. The question of how we intend to live (together) in the future is still before us and is as yet inconclusively answered, the merits of the concept of globalisation are up for discussion, and intercultural differences are manifest. In such a world, stock markets do not operate in a paralleluniverse that is confined to economic issues, but instead the market participants take these issues into consideration and they are reflected in the participants' decisions, often influenced by hope, disappointment, fear and euphoria. This is why we are of the opinion that the impact of political contexts on the development of global stock markets will become even greater and also remain difficult to predict. The disturbing factors described here will continue to give rise to nervous background noise in the markets, which

Nervous background noise, high volatility, limited expectations.

will keep volatility high and limit expectations. They are difficult to understand, cannot be measured and their relevance cannot be predicted. This is the basis of our assumption that the achievable returns on the capital markets will remain comparatively low in all segments and that fluctuations will have to be exploited in order to generate above-average income.

Regarding returns, since the beginning of the "new world order" almost 30 years ago, interest rates have fallen. This is certainly no coincidence. The Cold War ended, the world became more reliable, and globally active investment capital was interested in financing the change. When the prosperity began to falter, the central banks compensated by lowering interest rates further, thus allowing the party to continue. However, the end of this approach has apparently now been reached – quite simply because it cannot go any lower. Admittedly, looking back, negative interest rates have been implemented, but these have not yet fallen below minus 1% and have never stayed in negative territory for very long. Moreover, the conviction that negative interest rates are anything but wise seems to have taken hold very quickly. Japan is still working on the consequences, and America has fortunately never become involved in such nonsense, while Europe is looking for a way back.

Reviewing our Assumptions

Given this background, what is the status with our previously core assumption that interest rates will remain very low for a long time? This forms the basis for the assessment of which investment segment can provide the best yield contributions.

Many things that were claimed and proposed in the election campaign will not end up being implemented.

In this context, a brief digression about economic expectations is presented, as these have an impact on the interest rate trend. This was particularly evident with the election of Trump, with interest rates on long-term US treasuries rising from 1.8 to 2.4 percent almost overnight as a result. This was an expression of pure economic optimism, as an economic boom would increase capacity utilisation, create room for manoeuvre in terms of passing on price rises and encourage inflation. Trump wants to invest billions in infrastructure and raw material development. He wants to unleash the banks again and protect America from countries that can produce goods more cheaply. He wants to reduce corporation tax from 35 to 15 percent; such a low rate was last seen in 1938. If all his plans were to be implemented, higher rates of inflation would most certainly be expected, accompanied by significantly increased interest rates. Admittedly, many things that were claimed and proposed in the election campaign will not end up being implemented. For example, who will fill the numerous low-paid jobs in the American agricultural sector, if not low-wage workers from Mexico? Who will build the many iPhones and iPads, if not the world's largest electronics supplier Foxconn in China? How should all the tax reductions that were announced be financed? What problems will the budget experience when investors expect higher yields because of falling borrower quality?
Regardless of what actually happens, "Trumponomics" has already given

We believe that the economic cycle in the US will be extended by another year.

rise to one thing: an enormous rush of optimism. The US consumer confidence survey, measured by the University of Michigan, most recently jumped from 109 to 113 points, thereby reaching a 15-year high. We believe that this confidence in the economy will last for some time and that the economic cycle in the US will be extended by another year. This expectation would, however, have to be changed immediately if Trump turns out to be serious about the idea of starting a trade war with China, which would border on economic suicide.

INFLATION AND INTEREST RATES

Whether or not effects that drive up prices do actually arise will depend, therefore, on how quickly capacities can be exploited and to what extent casting a protectionist net around America can succeed at all. Trump has, in any case, achieved what the central banks have failed to achieve in many years of trying, which is increasing inflation expectations. Another factor is the effect of the very low commodities prices last year; higher average prices are expected in the current year. Moreover, the historically low rate of unemployment in the USA could lead to rising prices as the economy grows. These factors form the basis for an increase in inflation expectations that it is already possible to discern .

Inflation rates climb again, but remain below central bank targets

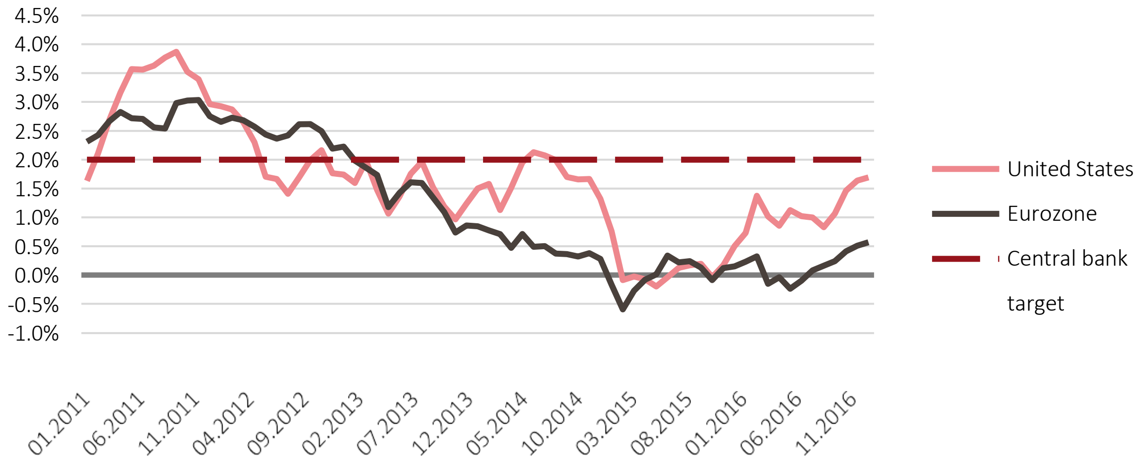

Figure 1 *Source: Bank for International Settlements*

Nonetheless, we do not see much inclination among central banks to dampen these expectations by increasing interest rates. Despite the election result, yields on US treasuries are still below the level of a year ago. In addition, the Head of the US Federal Reserve recently stated that she could imagine allowing inflation to "heat up" for some time, in order to support economic growth. The ECB has already extended its quantitative easing programme of bond purchases.

There is less concern about inflation than deflation.

Politicians are much less concerned about inflation than a deflationary spiral. The need to refinance the accumulated debt also requires low interest rates, as public budgets otherwise threaten to collapse. A wide spread between low interest rates and the desired higher inflation could indeed be encouraged. The result would be the so-called financial repression: private households are expropriated by inflation, without being able to counterbalance this with savings opportunities. In effect, an additional tax, via which the public debt can be depreciated faster and thus reduced.

But what if inflation increases more strongly and more quickly than expected? A not negligible possibility, especially as there are already shortages of skilled workers in the USA as well as in the economically stronger parts of Europe. An economic upturn could make labour costs more expensive and trigger a price spiral. We believe that the potential of seeing interest rate rises in the USA is limited in this scenario as well: rising interest rates in the USA have usually been accompanied by an increase in interest rates in other countries as well in the past. Countries and companies have competed in the bond market of this reserve currency. So a similar but often temporally delayed interest rate trend in the industrialised countries was previously observed. Such a parallel upwards shift in interest rates is, however, unlikely to be possible for a variety of reasons. These include the fact that Japan has still not shaken off the ghost of deflation, so an increase in interest rates there could implode the currently poor growth and collapse the budget in the face of high debt. Europe, on the other hand, is still suffering from the crisis resulting from the protracted implementation of reforms. A perceptible increase in interest rates would push peripheral European countries to the abyss and the Eurozone would once again be virulently endangered, which is why the ECB is not promising anything like that. Surrounded by such low interest rate competition, the FED is likely to find it difficult to achieve a sustained upward trend in America, as a resulting inflow of capital would strengthen the USD and weaken the competitiveness of America on world markets. Rate rises in America are therefore likely to find a natural barrier at this point.

Interest rate increases are likely to find a natural barrier in the form of the strength of the US dollar.

Last but not least, in its World Outlook issued in October 2016, the IMF basically considered the same challenges to exist as was the case a year ago: low growth and low demand around the world, declining international trade and deflation tendencies. It noted the continuation of political uncertainty, with a tendency towards de-globalisation. And it formulated the hope of a consistent economic policy on the part of the G20 in order to counter these tendencies. Reading between the lines, it also encourages keeping interest rates low and capital resources for the economy high.

Interest rates will remain low for a long time.

We therefore maintain our core assumption and thus the essential pillar on which the stock markets are based: interest rates will remain low for a long time. However, the most important criterion for the attractiveness of companies is their expected profits. In this regard, there was recently an occurrence that has not been seen for many years - while analysts in recent years estimated expected profits to be ever lower, the closer the balance sheet date came, the more expectations shifted. In the USA, approximately the same estimates were made for the 2016 profits in the S&P 500 at the end of the year as had been issued at the beginning of the year. In Europe, the average profit expectations for the coming year are even rising again. Dampened expectations being revised upwards was something that was last seen here in 2009.

Recommendations

We are still looking in vain for safe havens.

In view of the bigger picture described here, the issue of a sensible distribution of assets is now more urgent than ever before. As already established a year ago, there is a discrepancy between the unstable world financial system, with little room for manoeuvre, and the risk tolerance of the markets which nevertheless remains high. Never has debt been so high and interest rates so low as is currently the case. Rarely has the political configuration of the world been as fragile as it is today. Diametric extreme scenarios have equally high probabilities of occurring. We are still looking in vain for safe havens, as considering the risk of the devaluation of an investment in fixed-income securities for inflationary reasons or, in the worst case, because of a debt haircut, no or a too low interest rate is still offered, unless other risks such as currency losses are taken into account. In addition to this, bonds are subject to certain price losses in the event of rising interest rates. Last but not least, there is a risk that extreme events could cause risk aversion on the markets to become so great that all investment categories will suffer substantial losses, including bonds. 2008/09 is the best example of this.

We therefore continue to recommend investment in property.

We therefore continue to recommend investment in securities that do not lose their underlying value even in turbulent waters – such as holdings in a company or ownership of a property. As, even if extreme scenarios are assumed, dividends and rental income are likely to remain viable. They will fluctuate overall, but will not completely disappear. Investors taking a long-term perspective should therefore continue

Dividends remain relatively stable, even in times of crisis with falling profits (2005 = 100)

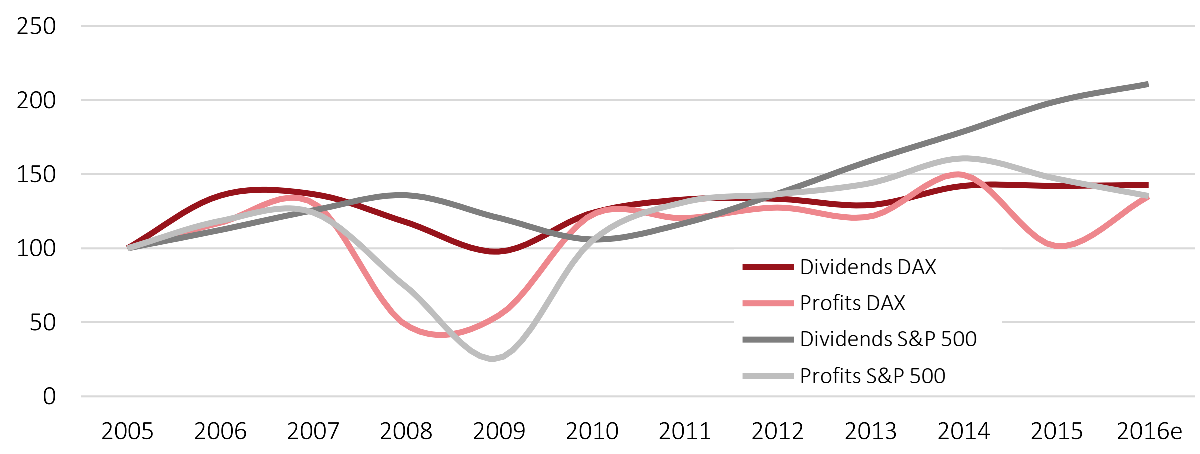

Figure 2 *Source: multpl.com, boersengefluester.de*

to have the majority of their capital invested in equities. Target companies should have a sustainable business model and pricing power. They should ideally be drivers of technical progress and/or sell products and services that meet basic needs. In view of the expectation of high price fluctuations, a goal-oriented strategy could be to keep, in a disciplined way, part of the planned investment in shares in liquid form, in order to be able to invest this in the event of major setbacks, and then liquefy it again following the subsequent recovery.

Focus on Europe, emerging markets, commodity-dependent investments ...

As far as our regional preferences are concerned, the profit expectations for America seem least certain, as they are strongly dependent on the still uncertain potential of the new president's ideas. In this respect, a foot should remain in this door without overweighting the region. With regard to emerging markets, we see further favourable conditions for commodity prices as a result of the establishment of a floor in the market. The dependence on business relations with America, apart from in the case of Mexico, is not so pronounced that more serious impairments would have to be feared if the USA actually wanted to establish a large-scale protectorate. For Europe, a stabilisation in growth is expected, which would however be shaken again by a new outbreak of the euro crisis. We continue to see positive developments in industries that promote commodities. The commodity prices appear to be low with regard to the overall increase in world economic growth and offer potential. Shares in this investment segment would also be among the beneficiaries if interest rates increased unexpectedly strongly.

Financials, commodities and automotive shares often benefit from rising interest rates

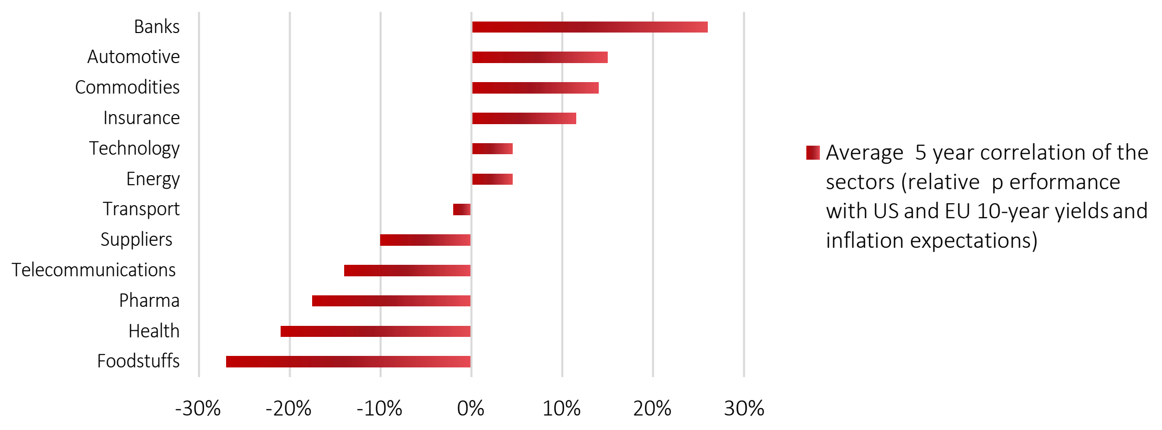

Figure 3 *Source: Morgan Stanley*

... as well as precious metals.

The fact that we, taking into account the environment described above, continue to advise protecting oneself against extreme events, thus recommending the retention of a basic holding of precious metals, seems a given. A gold price that rose by more than 8% in 2016 reflects the increased nervousness on the markets. Meanwhile, shares in precious metal producers have reached a very low level, which we believe does not adequately reflect the yield consistency achieved by these companies as a result of the implementation of structural changes.

For investors, this is not a time in which clear answers are being provided to simple questions. We see this challenge as an opportunity. We would be more than happy to discuss our thoughts and explanations with you.

Bielefeld, 10 January 2016
Matthias Steinhauer

Legal Notice

This publication has been prepared by CONCEPT Vermögensmanagement GmbH & Co. KG (CONCEPT). It is intended solely for information purposes and may not be reprinted or made publicly available without the explicit consent of CONCEPT.

The information contained in this publication is based on sources that CONCEPT considers to be reliable but which are not subject to neutral oversight. The information is publicly available. CONCEPT provides no guarantee or liability for the correctness and completeness of the information. The opinions expressed in this publication represent the author's opinion and are subject to change at any time. Such changes of opinion do not have to be published.

The information contained in this publication is based on historical data as well as assessments of future market developments made by CONCEPT. These market assessments are obtained using analyses that are prepared with the requisite conscientiousness and diligence. Nevertheless, CONCEPT cannot assume any guarantee that such developments will occur. The value of an investment made on this basis can fall or rise, and some or all of the invested money may be lost.