Check-Up

Client Newsletter of Privatbankiers Reichmuth & Co
Integral Investment Management | September 2016



Editorial

Despite Brexit, terrorism, and banking problems in Europe, not to mention an attempted coup in Turkey, the financial markets are posting gains. So what can possibly go wrong? No matter what the problem might be, central banks seem to be on hand to sort things out. Interventions in the financial markets are therefore continuing to determine prices, and remain the dominant theme. Risk-free interest-bearing securities have become interest-free risk-bearing securities. This poses challenges for us all, and you can expect us to address these with a forward-looking approach centered on taking responsibility.

I was delighted at the positive feedback we received for our Integral Circle events. The tremendous trust that has been placed in our infrastructure fund, with commitments totaling CHF 250 million, also shows me that we are on the right track. We are therefore looking to the future with considerable confidence.



Jürg Staub, General Partner

EVERYTHING UNDER CONTROL?

Sovereign debt sustainability and prices have their limits

The central banks have been the decisive players on the financial markets for eight years now. They are the ones that set the risk-free interest rate, that are flooding the market with money, and that are constantly coming up with new approaches to firefighting. The Bank of England also acted immediately after the Brexit decision, announcing interest rate cuts and an expansion of the asset purchasing scheme for UK government bonds.

Inventive central banks

Confidence in the central banks is high, in our view excessively and dangerously so. Why will they not say that they have run out of options and that the problems of the future can only be tackled by politicians? All the central banks can do is buy time for policymakers. Unfortunately, they are continuing to insist that they still have plenty of resources at their disposal. For example, former US Federal Reserve Chairman Ben Bernanke has written (www.brookings.edu) about the tools the Fed could resort to in the event of a renewed recession in the US: 1. introduce negative interest rates, 2. target longer-term interest rates, and 3. distribute helicopter money.

The dose makes the poison

Negative interest rates have been a reality in Europe for more than two years, and Japan has also been experimenting with them of late. Fortunately, the realization now appears to be dawning that these measures will have a disastrous impact on pension schemes, on the banking system, and on the confidence of consumers and investors alike. There is no readily apparent and politically viable way out of this folly without losing face. US and UK decision-makers seem to be, however, increasingly distancing themselves from negative interest rates. The second instrument of financial repression – capping interest rates on bonds up to a certain maturity at 1 %,

continued on next page

for instance – was also already deployed in the last century. Here, too, the objective was to push real interest rates below zero.

Helicopter money becoming acceptable

A third instrument – so-called helicopter money – is increasingly being discussed. As the image suggests, this would be akin to dropping money, as if from a helicopter, that would never have to be repaid, thus permanently increasing the money supply. There is a whole range of different forms this could take. Many already see quantitative easing as a form of helicopter money. Others think of a helicopter distributing money equally across the population, while yet others want it to hover over parliament and for the non-repayable largesse to be dispensed by the government.

Limits to sovereign debt sustainability

Interest rate cuts can be used to mitigate a shock and to lower financing costs, and can also bring forward several years of future consumption. However, protracted use of this instrument reverses the consumption effect. As fears over the future mount, people save more. Hence the increasingly vocal calls for a more expansionary financial policy. We abhor the prospect of higher state spending, while lower taxes would be more in keeping with our liberal stance centered on taking personal responsibility. Both approaches would temporarily result in higher sovereign debt. However, this also cannot be increased indefinitely – here, too, there is a sustainability limit. When it comes to calculating the affordability of mortgage loans, banks use a normalized interest rate of 5 %, and the burden may not exceed ⅓ of the person's income. In the case of states, it is based on the fiscal capacity. If we were to make a similar assessment of sustainability for governments, many countries would already be stretched to their limits, or even beyond. One thing is clear: as sovereign debt increases, the country's credit rating suffers; this is one of the reasons why helicopter money is attracting ever more attention.

Price limits on sovereign debt

With interest rates below zero, the prices of bonds in circulation have swelled. Is there a ceiling for the price of sovereign debt? We are convinced there is, and this limit is probably reached when the yield edges below zero. Imagine lending money to the highly indebted Italian state for three years without getting anything in return. On the contrary, in fact, imagine having to pay for the privilege! What better reminder of the difference between price and value? This is why Kenneth Rogoff is advising emerging markets embarking on quantitative easing programs of their own to buy gold rather than western sovereign debt. After all, despite the fact that the volume of gold is limited, unlike government bonds, there is no upper price limit. With an ever greater part of the exorbitantly priced government bonds being buried in central bank balance sheets via quantitative easing, they are also no longer available as collateral for global trade. US economist Barry Eichengreen sees this as having a curbing effect on growth. In other words, even the new policy of quantitative easing has its limits!

The status quo, at any price

The efforts that will be expended to preserve the status quo should not be underestimated, and we are likely to continue down the path of financial repression. However, what would happen if the Italian government were to lose the constitutional referendum in November? Or how would Europe, already buffeted by Brexit, terrorism, and the disputes over migration, react to a possible recession?

What should we do?

In our view, the most likely scenario is that of muddling through. Interest rates seem firmly entrenched around zero. The closer to 0 % that future earnings are capitalized, the more exponential the result. Against the backdrop of cheap money, the bubble formation scenario is likely to continue to gather momentum. Bonds remain unattractive. Depending on their personal circumstances and investment horizon, investors should increasingly diversify their sources of returns. Possible options in this regard include insurance-linked securities (ILS), infrastructure, and emerging market bonds. However, our primary focus remains on stocks offering strong dividends. If bubble formation were to persist, and depending on the client's individual tolerance in respect of corrections, put options would offer a means of insurance. These would have to be used tactically, for example now, in the run-up to the US elections. Long-term call options with a high strike price on the gold price would also be one form of insurance against mishaps resulting from central bank policies geared toward financial repression.

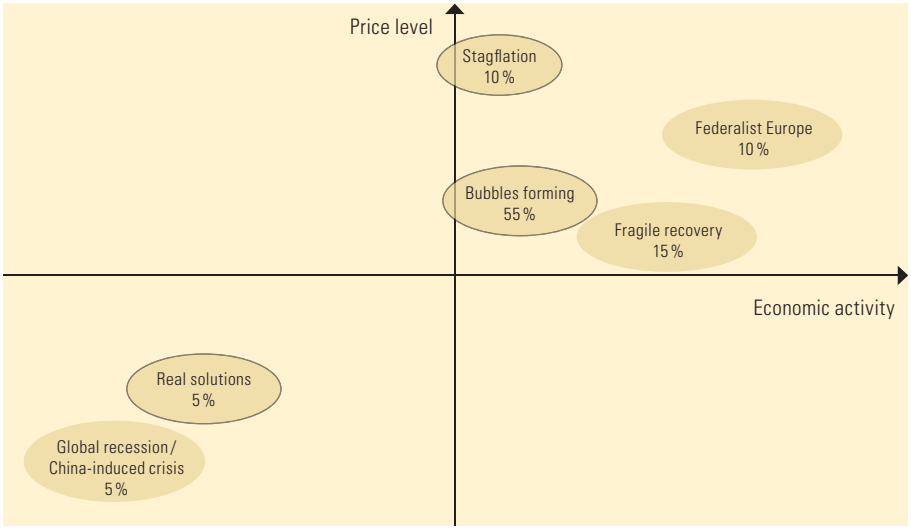
Such a broad diversification of investments, coupled with regular reassessment with a view to the future, will hold the key to success over the coming years.



Christof Reichmuth, General Partner

BUBBLE FORMATION IN THE OFFING

Our take on the future



Framed = Scenarios described below

Summary

- Extreme interest rate situation and dearth of alternatives bolstering bubble formation.
- Global recession risks abating over the short term.
- Stagflation less likely in the US in short run; probability increasing over medium term due to tentative interest rate policy.

Primary scenario: bubble formation – financial repression and stagnation

Persisting imponderables prevent a global economic upturn. Share buyback programs and higher dividend payout ratios are given preference over investment in growth. Negative economic developments are immediately countered with further monetary policy measures. Helicopter money is on the table, and the aberrations resulting from negative interest rates become more acute. The formation of bubbles moves into the final and most extreme phase, spreading from bonds into the equity market. Doubts emerge over the intrinsic value of bonds and paper money.

Investment ideas

- Dividend stocks
- Stocks of global leaders
- Real estate
- USD
- Underweight cash

55% probability 3 – 6 moths

Real solutions – shaking out and looking to the future

The political consequences of the vote in favor of Brexit and the banking crisis flaring up in Europe put renewed pressure on the markets. Teetering on the brink, a political re-think takes hold, and structural reforms are launched. Systemically important banks are recapitalized, with an enforced consolidation of the sector. The crisis-hit countries reach agreements on debt haircuts with their creditors. A "bad bank" is set up to handle this. A new central banker with some backbone calls a halt to the extraordinary monetary policy measures to put proper investment incentives in place for the long term. Following a turbulent phase with a pronounced slump in asset values, solid foundations are in place once again for fresh beginnings.

Investment ideas

- Cash in CHF
- Equities (home bias) hedged with put options
- Alternative sources of returns (e.g. ILS or hedge funds)

5% probability 3 – 6 months

Stagflation – no growth and higher inflation

The US economy is in solid shape and unemployment stabilizes at a low level. In light of the fragile global environment, however, the Fed deliberately holds off on further interest rate hikes to prevent renewed stress on the financial system. Wages in the US begin to rise, bringing pressure to bear on margins. Inflation rates clearly above the 2% target are welcome in the central bank's view as this helps lower the debt ratio. Real interest rates fall further into negative territory, weakening the USD. Inflation in the US outpaces wage rises, resulting in a loss of purchasing power with detrimental consequences for consumption. The weaker USD has a positive impact on certain emerging markets.

Investment ideas

- Overweight gold
- Inflation-linked bonds
- Underweight nominal assets
- Emerging Markets
- Avoid USD

10% probability 3 – 6 months

BREXIT – AN OPPORTUNITY FOR EUROPE?

Politics having scant impact on financial markets thanks to expansionary central banks



Patrick Erne, Head of Research

The central banks are continuing to support the financial markets with ultra-aggressive monetary policies. Brexit marks the first time a protest movement has won an important referendum. This could trigger structural reforms.

Political imponderables weighing on growth

The growth prospects in Europe in particular are not especially good. The vote in favor of Brexit has for the first time clearly shown that there are indeed majorities in European countries that believe they would be better off going it alone than sticking with the EU joint venture. With their historic decision, the British are prepared to accept a possible recession. However, given the generous supply of liquidity, the risk of contagion spreading to Europe appears small thus far. Brexit would be an opportunity for Europe to tackle structural issues and pursue delayed reforms, but there has been no sign of such initiatives to date. Without a realignment of the EU, we expect to see mounting economic and political uncertainty. Capital spending will fail to materialize, or will be postponed to an undefined point in the future. Such a development would be detrimental to long-term growth in Europe. Without growth, and with the increasingly unequal distribution of assets, the risk of protest votes will rise, not just in the EU but also in other parts of the world. In October, Matteo Renzi will put a constitutional change to a popular vote in Italy. If this were to be defeated, there would be the threat of a further government crisis in highly indebted Italy, and Eurosceptic protest parties could gain the upper hand there too. Despite the ECB's bond buying program, this would lend fresh impetus to the debate over the sustainability of sovereign debt in countries such as Italy.

GDP growth expectations	Current GDP growth	Growth expectation (12 months)
United States	1.2 %	1.8 – 2.2 %
Europe	1.6 %	0.8 – 1.5 %
Switzerland	0.7 %	0.8 – 1.2 %
Japan	0.6 %	0.5 – 1.0 %
China	6.7 %	5.0 – 6.0 %

Monetary and fiscal policy fusing

Even though there is mounting criticism of the expansionary monetary policies of the central banks, and the benefits of these are increasingly being called into question, there is no quick turnaround in sight. On the contrary, we expect to see a further expansion in the current programs of purchasing financial assets in Europe and Japan. Given that fiscal spending is being stepped up at the same time, and financed indirectly via the central banks, drawing a distinction between monetary and fiscal policy is becoming ever more difficult. The US Federal Reserve's tentative stance is ensuring that the supply of liquidity remains high worldwide. If inflation rates were to rise above the actual target of 2%, coupled with a solid labor market, criticism of the Fed would likely increase, pushing interest rates back up slightly at the long end. The interest-rate differential still favors a somewhat stronger USD, even though the appreciation potential is limited by rising US inflation. Generally speaking, yield curves have become very flat. This makes pure duration strategies with long terms to maturity in the fixed-income segment unattractive. Spread strategies in the case of US corporates or emerging market bonds are somewhat more appealing.

Interest rate expectations	3m rate (Libor)	Expectation in 12m	10y swap	Expectation in 12m
United States	0.8 %	rising slightly	1.4 %	rising
Europe (Germany)	– 0.3 %	unchanged	0.3 %	unchanged
Switzerland	– 0.7 %	unchanged	– 0.3 %	unchanged
Japan	– 0.0 %	unchanged	0.1 %	unchanged

Equity markets becoming more bloated

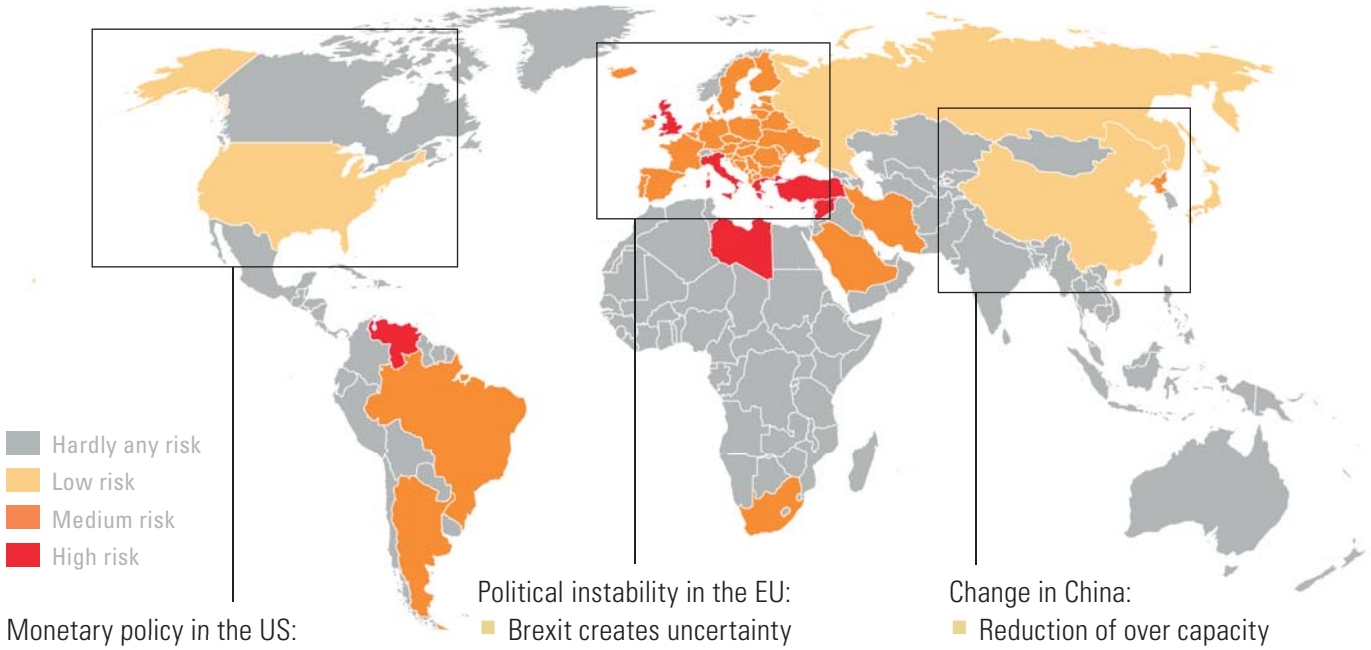
The signals for the equity markets are contradictory. While the fundamental valuation figures in certain markets appear expensive, and investor sentiment is once again increasingly urging caution, expansionary monetary policy will remain the driving force for the equity markets over the medium term. The strong US stock market stands out, trading at historic highs. As regards most of the other western equity markets, some are still clearly below their peaks. Earnings expectations currently appear realistic. Margins are historically high only in the US, and with inflation picking up somewhat and wages rising slightly, the US markets appear to be the most vulnerable.

The pivotal question is that of the correct multiplier. Simplified valuation models state that the fair value of an equity market can be determined by dividing earnings by the risk-free interest rate plus a risk premium. As long as interest rates are positive, the corresponding target value can be ascertained. With negative interest rates, it is no longer possible to determine the fair value of the equity market since the target value increases to infinity. The risks are thus based less on the current earnings of companies, and much more on the high valuation stemming from the low or negative interest rates. As regards regions, we are giving preference to the European stock markets that remain supported by an extremely expansionary monetary policy with negative interest rates, as well as certain cheaply valued emerging markets in Asia or Russia. The focus in terms of equity selection is on quality stocks in defensive sectors, and also Swiss small and mid caps. In light of the advanced cycle and the above-average valuation of the equity markets, we are increasingly making use of tactical hedges in the form of put options, and diversifying into alternative asset classes such as gold, hedge funds, real estate, and insurance-linked securities (ILS).

Equity valuations and expectations worldwide

Market	Index level 19.08.2016	P/E	P/S	P/B	D/P	Expectation 12 months
S&P 500	2179	18.6	2.0	2.9	2.1	rising slightly
DAX	10544	13.6	0.8	1.7	2.9	rising
SMI	8127	17.9	2.1	2.5	3.6	rising
TOPIX	1296	13.3	0.7	1.2	2.2	rising
China H Shares	9606	8.2	0.9	0.9	3.9	rising

Macroeconomic risks



Monetary policy in the US:
- FED facing balancing act
- Core inflation already over 2 %
- US elections

Political instability in the EU:
- Brexit creates uncertainty
- Italy: Restructuring banks and pol. referendum
- Refugee crisis

Change in China:
- Reduction of over capacity
- Bad loans from unprofitable government owned companies
- Opening of the capital markets

OVERVIEW – ASSET CLASSES

Quality stocks remain attractive but susceptible to fluctuations

Bonds

- Clear flattening in yield curves exacerbating unattractiveness of asset class.
- Swiss bond market in an artificial coma, Europe much more dynamic thanks to ECB's purchasing program.
- Opportunities in US corporates and emerging market bonds.

Equities

- Our bubble formation scenario continues to support quality stocks from more defensive regions and sectors.
- The high valuations in some cases, coupled with risks that should not be underestimated, justify partially hedging the US and Europe.
- We are supplementing our emerging market equities portfolio with an initial investment in Russia.

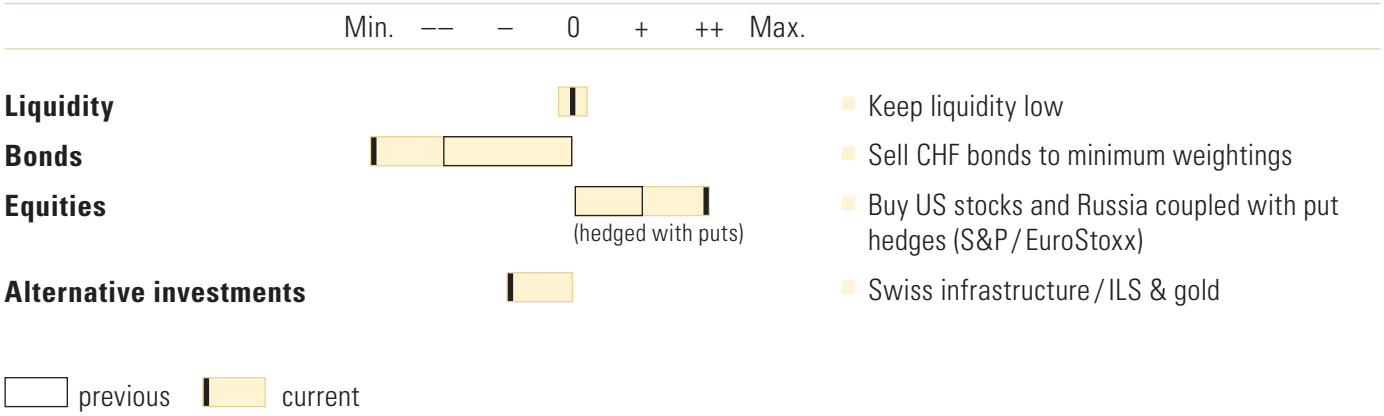
Alternative investments

- Wherever possible, we are replacing bond investments with negative yields with comparably stable alternative sources of returns: rental or interest income in the case of infrastructure and real estate as well as insurance premiums for ILS investments.
- Our preferred hedge fund strategies come from the event driven (merger arbitrage) and long / short segments. After years of underperformance, commodity prices appear to be finding a foothold.

Currencies

- The strength of the JPY has surprised us, and is putting pressure on the Bank of Japan to make a move.
- We increased our GBP exposure after the Brexit referendum.
- Gold remains a key currency component for us, and we are also overweight in USD and GBP.

Positioning



Please note:
If you would like to receive a copy of our Investment Policy publication with detailed market assessments, please contact your relationship manager or register with Nadine Vonwyl (nadine.vonwyl@reichmuthco.ch).

SUCCESSFUL SWISS SMALL & MID CAPS

Product and performance leaders

Switzerland has a wealth of well positioned smaller and medium-sized companies that are market leaders in their niches. Many are internationally active, and the strong CHF has forced them to cut costs and increase efficiency in recent years. They have good products and a strong competitive position, coupled with fundamentally healthy balance sheets and solid cash flows. Given that many of them are scarcely followed by analysts, the market is not very efficient. This opens up opportunities for experienced and active investors like us, who are in direct contact with the management of the companies and can get information first hand.

20 years of Reichmuth Pilatus

With Reichmuth Pilatus, we have been investing in Swiss small and mid caps for our clients for nearly 20 years. Since its inception in December 1996, it has posted a cumulative performance of 360 %, or 8 % per annum. This is around 100 % better than the broad Swiss equity market (SPI) over the same period or 2.5 % p.a. Our value-oriented style is tried and tested, and has proven its worth. Investors frequently act pro-cyclically and end up with concentrated risks in their portfolios. Reichmuth Pilatus therefore invests in around 25 promising companies with the following two characteristics.

Owners that take the long view

The first group comprises technology leaders with high innovative strength, first-class products, exacting quality standards, and a dominant global market position. Added to this, they have management teams looking to the long term, and whom we trust. Ideally, these companies will have a strong shareholder group serving as an "anchor", e.g. a family that shares the long-term view and gives management the opportunity to pursue a strategy looking far into the future. The equities of such firms form our core positions, and account for around ½ of the portfolio.

Opportunities – companies in transformation

The second category within the portfolio comprises companies that are undergoing a major transformation. This may entail a structural change, a strategic realignment of the business model, or a restructuring of the business. We make such investments in anticipation of key events that will have a positive impact on business performance and on the share price. The investment horizon of such investments is generally shorter, and the portfolio turnover higher. We usually sell these positions entirely when the investment idea has been borne out, and also if it is proven wrong.

Swiss small and mid caps – an interesting addition

We continue to regard the Swiss small and mid-cap segment as an attractive home-currency addition to portfolios over the long term. However, investors must expect heightened price fluctuations in this area. We therefore always recommend holding the core position across the entire cycle, while taking advantage of slumps to make increases. The companies have got themselves into good shape in recent years, and have optimized their cost structures. Should the world actually return to a growth path, these firms would be excellently positioned.

Reichmuth Pilatus over 20 years with 8 % performance per year



Source: Macrobond, Bloomberg (Data per: 22.08.2016)



Silvan Betschart,
Asset Allocation and Research



Philipp Murer,
Portfolio Manager Reichmuth Pilatus

ROBUST, ACTIVE & BOLD

Interview with Marcel Schnyder on Reichmuth Investment Management

Mr Schnyder, you have been with Reichmuth & Co for a year now. How do you like it here?
A lot! I was specifically on the lookout for a company with a dynamic, entrepreneurial culture – and that's exactly what I've found. In light of the changes in the banking world, and investment management in particular, there's an incredibly diverse array of opportunities on offer for us. Our team of young, well-qualified and highly motivated employees is firmly established, and it's now a matter of setting the right priorities and seizing these chances.

What opportunities do you see specifically?
In terms of business policy, we need to focus on the essentials, on our own core competencies. For me, that means client-driven solutions in the segments where we feel at home. This is where we can add value.

With regard to the financial markets, the chances are more multi-faceted, but so too are the risks. The low interest rate environment is driving the prices of traditional investments to an unhealthy extent. As a result, alternative investment areas are being tapped into that are not suitable for all, and that are in some cases, still sparsely regulated. There is often no joined-up portfolio management structure defined with the clients that takes the various risk factors into account. In some cases, highly indebted governments and companies are receiving money on the bond market at insane terms! We also see the trend towards the passive investment style as being dangerous. Investment decisions that closely track an index do not necessarily mean risk-free portfolios – increasingly, the opposite is the case. And last but not least, the glut of information coupled with purely computer-based investment strategies is leading to market distortions, which could have destructive consequences for those that behave pro-cyclically.

What are your core competencies? Where are your strengths?
We see our strengths in four areas. Firstly, we are asset allocators with clear opinions, i.e. on advice and implementation with regard to strategy portfolios. Secondly, we have long-standing competencies in Swiss stocks, with a focus on Swiss small and mid caps. For two decades now, we have also been selecting external managers with active strategies in alternative asset classes, and about four years ago we built up our activities in the Swiss infrastructure segment.

What milestones have you achieved in your first year?
In the past twelve months, we have been able to develop the former fund management company into an asset manager authorized by FINMA. We have strategically strengthened the specialist teams with new hires. Our strategy funds have been redesigned: the portfolios are more robust and investments now cover additional elements. The traditional BVG strategy fund has been renamed 'Alpin classic', and our range has been supplemented with 'Reichmuth Voralpin', a fund that seeks to keep fluctuations to a minimum. This addresses the needs of investors with a shorter horizon, especially against the backdrop of negative interest rates. Added to this, we have developed the tactical asset allocation together with risk management. Thanks to such clear and bold decisions, we can now enjoy good performance.

What is your recommendation for your clients?
They should focus on a robust portfolio structure. What I mean by this, is that they should take their personal needs and possibilities into account when making their investments, and they should diversify them across different asset classes, regions, sectors, and securities or managers. They should form their own opinions, take active decisions, and stick to their bespoke, individually defined investment strategy. This also calls for a certain amount of resolve, but they should avoid excessive emotion, particularly when it comes to tactical investment decisions.



Marcel Schnyder, CEO Investment Reichmuth Management
In his 20-year career, he has received some 40 Lipper & Morningstar awards for the best strategy fund results over 3–5 years in Europe.

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