Check-Up

Reichmuth & Co Private Bankers Client Newsletter
Integral Investment Management | September 2017



Editorial

The majority of investors are pleased with the good performance this year. Ten years after the financial crisis, financial markets and the economy are in a much better shape. While this is certainly good news, it is always wise to continue looking ahead once things improve. Although the normalization of monetary policy by the central banks is earnestly desired, it will also create certain challenges.

"There is nothing that the world is longing for more than a real private bank." That is not our own statement, but rather one made during a conversation with a very interesting individual who visited us. This statement is a great motivation to continue following the path we have chosen. Along the way, we are learning a great deal from our clients, and we would also like to thank you for your loyalty.



Jürg Staub,
General Partner

SPRINGTIME IN EUROPE

Is the EUR crisis over?

Thanks to Europe's super election year in 2017, a clearer picture of a possible future direction for the EU is slowly beginning to form.

After the elections in the Netherlands, a hastily called parliamentary election in England, and the French voting marathon, the election year is drawing to a close. Only the rather less exciting German Bundestag elections are still to come this month. Amazingly enough, the pro-EU forces have once again regained their strength in 2017 following the shock waves from last year. In particular the charismatic and telegenic French president, Emmanuel Macron, appears to have turned things around for the European Union.

Will the new EU become a federation?

The French presidential election not only shook the established order of political structures in France, it also demonstrated that the will to reform extends beyond national borders. The signs pointing toward a possible long-term "European core" scenario are thus multiplying. This would involve significant changes of some key tasks, such as defence and migration – each of which would require a corresponding budget. Whereas today's EU is a union of states, a "Core Europe" would require an effective executive branch with a special parliament to deal with areas such as tax jurisdictions. The current commission of technocrats would thus have to give way to a lean federation. Angela Merkel is seeking re-election in Germany and her initial statements have indicated a degree of willingness when it comes to future structural changes. A possible development in the direction of a transfer union – although still undefined in terms of scope – would thus be pursued. Which countries would participate in the longer term in such a core union is still completely unknown; Germany would no doubt take on a leadership role along with France.

France en marche – words vs. actions

Margaret Thatcher achieved success in the United Kingdom by making radical reforms. Can Emmanuel Macron accomplish something similar? He wants to and must liberalize the sluggish job markets

Continued on the next page

in particular. Macron's statements regarding the future-oriented society of France or the entire EU are encouraging, yet his initial actions do not back up his words. For example, he recently nationalized the French shipbuilder STX France, with the supposed aim of protecting jobs in France and improving his negotiating position with Italy. According to the original agreements, the Italian shipbuilder Fincantieri was to take over 48% of the shipbuilding company STX France after separating it from the highly indebted, South-Korean parent firm; an additional 7% would have gone to the Italian investor Fondazione CR Trieste. As such, only 45% of the new company would have remained in French hands – too little for the French president.

Is the EUR crisis over?

Europe's economy is on the upswing. The elections have restored political calm and confidence, allowing the EUR to strengthen for the first time in years. Now that the risk of a EUR collapse in the short and medium term hardly exists, it is tempting to assume that the EUR crisis is over. Unfortunately, however, no sustainable solutions for high government debt, pension obligations, structural imbalances regarding competitiveness etc. have yet been found. Without real reforms, these tensions will continue to mount.

Regime change for central bank policy

For investors, however, the upcoming exit from the ultra-expansionary central bank policy in the USA and Europe is more important over the coming months. Whereas up until now the US Federal Reserve has been replacing expiring bonds as part of its quantitative easing program, it wants to reduce this measure going forward. The ECB is also indicating that it is considering a withdrawal from its bond-purchasing program and negative-interest-rate policy. The slight rise in central bank interest rates and reduced demand from non-price-sensitive buyers make for an intriguing mix. A lower demand for the available supply seems to be in the forecast. A great deal of money has indeed been generated and lots of money is waiting for attractive investment opportunities, yet no one knows what type of returns are required to make investing attractive enough. In our opinion, however, a rise in interest rates of at least 1% is necessary.

Market = pricing mechanism

In free markets, prices are established through supply and demand via a process of trial and error, which is why markets are given to recurring exaggerated fluctuations – in both directions. Those in power may very well set price caps, but this results in imbalances and misallocations. Imbalances may emerge slowly or abruptly. In addition to central banks, there is an additional demand from investors who do not question or evaluate prices. These are the passive funds like ETFs, which are increasing strongly in volume (see also upper section on page 7). We would not be surprised if these "blind" investments were to become the trigger for future market corrections.

Situation analysis – what next?

Yes, bond markets are overpriced, and with the exit of the US Fed and the ECB we are losing two non-price-sensitive buyers. Yes, stock markets are expensive and a correction is probable as soon as interest rates normalize, i.e. rise. In addition, great sums of money are being funnelled toward anything that still promises a return, even when it involves illiquid instruments. There is even lots of money to inspire pure fantasy investments. And no, we are still not advising a withdrawal. Compared to nominal assets, we still prefer stocks and other investments based on true values.

Currencies react to political shifts

Those who must live off their assets alone should increase their cash reserves in the currency they use for purchases. We usually recommend having enough to cover your living expenses for a period of one to two years. Right now, however, three to four years are more appropriate in light of the expected stronger exchange rate fluctuations.

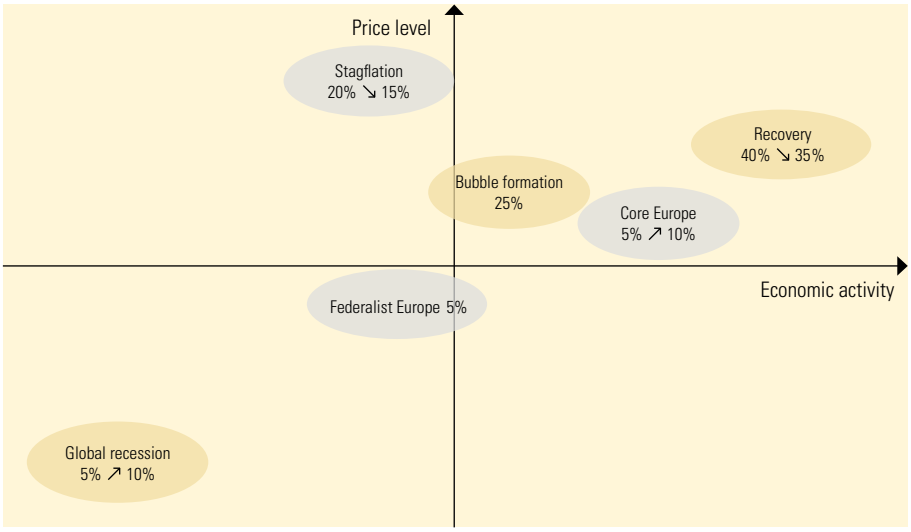
Those who can and wish to think about future generations as well should retain shares in companies and observe the legal tender for nominal assets. Although no real risk of a EUR collapse exists at the moment, a reform and/or change in structures is probable in the coming years. For this reason, we would only consider issuers with clear legal tender for EUR nominal investments and avoid supranational organizations, since one cannot know exactly how the repayment would be denominated in such cases. This is less important for shares, but for the same reason we would not undertake any currency hedging for shares in the northern euro area, because if the EUR strengthened (e.g. in the event of southern European countries leaving), this would affect share prices, similar to the situation for Swiss shares when the EUR/CHF 1.20 lower cap was lifted. Nevertheless, the EUR appreciating would neutralize share price pressure for a CHF investor. Since wealth management is ultimately a personal matter, such generalized statements should always be adjusted to match you and your individual situation. Our relationship managers are available at any time to assist you.



Christof Reichmuth, General Partner

EUROPE ACCELERATES

Our take on the future



Yellow = the scenarios described below

Summary

- Recovery scenario thanks to good economic data and minimal inflation pressure on prices
- Bubble formation remains on the radar as long as interest rates are barely or only slowly normalized
- A new European core zone makes a reinvigorated German-French alliance more likely.

"Recovery" scenario: Robust global economic development

The political blockade in the US is gradually resolved, and progress with planned economic-friendly reforms is also made. This has a positive effect on consumption, which is important for the US economy. The Fed increases interest rates by gradual increments and slowly trims its balance sheet, which is positive for the US dollar. Despite full employment, real interest rates remain positive because inflation can be kept in check and does not exceed the central bank's target range by very much. Economic recovery in Europe increases its pace, and political uncertainty gives way to a new sense of confidence. Global economic growth speeds up, and inflation remains under control for the time being.

35%
Probability
3–6 months

Investment ideas

- Overweight cyclical shares
- Avoid fixed-income investments
- Foreign currencies are attractive, especially USD
- Alternative, strongly correlated income sources like infrastructure and insurance-linked securities

"Bubble formation" scenario: Loss of confidence in central banks

Despite increasing discussions about a possible exit from the expansionary monetary policy, a trend reversal has yet to become visible. While the Fed is the first institution to experiment with reducing its balance sheet, the ECB and the BoJ are still far from doing so. The Fed increases interest rates only slightly despite full employment. Central banks in the remaining regions stick to their expansionary courses and keep interest rates low or even negative. Companies continue to invest less in growth and more in maintaining share prices. Share buyback programs and higher distribution yields are given preference over capital spending. Amid a lack of alternatives, investors flock to anything that offers returns. Bubble formation enters its final and most extreme phase.

25%
Probability
3–6 months

Investment ideas

- Overweight shares, focus on equities
- Underweight fixed-income investments
- Underweight commodities
- Overweight USD, gold
- Real estate

"Global recession" scenario: Three possible catalysts

1) The Fed overestimates the economy's robustness and continues to raise interest rates. Loan defaults increase due to high debt loads and lead to higher risk premiums worldwide. 2) The Trump government remains blocked politically and cannot create any new economic or geopolitical momentum. With the USA losing its dominant status, noticeable vacuums are created and the number of trouble spots increases around the world. 3) After years of credit-financed growth, debt levels in China exceed a critical level. Chinese economic growth declines more sharply than Beijing can compensate for with targeted measures, leading to catastrophic consequences for the global economy.

10%
Probability
3–6 months

Investment ideas

- Overweight cash
- Underweight shares
- Buy put options (selectively choose counterparty)
- Gold as a crisis currency

GO-AHEAD FOR BALANCE SHEET REDUCTION

New buyers sought for bonds



Patrick Erne, Head of Research

Global economic forecasts are good. Thanks to a job market that indicates full employment, the Federal Reserve will be the first central bank to undertake a balance sheet reduction project during the second half of the year. The consequences this will have for long-term interest rates are practically impossible to predict today, and although we are confident that interest rates will rise slowly initially, there is increased uncertainty about the long end of the interest rate curve.

Broad-based economic growth

The global economy is continuing to perform well. Europe in particular is maintaining its impetus, and the hope of structural reforms after the elections in Germany is growing. Even though the growth momentum in the Eurozone has subsided somewhat with the strengthening currency, we are still expecting a considerably stable economy over the coming months. The stronger EUR along with the positive economic climate in Europe are bolstering Switzerland's export economy. Despite a lack of momentum due to the stalled government in Washington, the US economy is performing reasonably well. As long as the job market continues to improve and inflation remains low, the consumer-driven US economy will keep growing. Should the US government succeed in overcoming the political blockade quickly and enacting planned tax reforms, slightly higher growth for 2018 could even be expected. However, the probability of this happening is not very good given the discord in Washington. The third-largest driver of the global economy – China – is building up some speed. Tightened regulations in the financial sector are aimed at slowing down bank lending somewhat, which could result in slightly lower growth rates. In any case, however, after the upcoming party congress in the autumn, everyone will have a clearer picture of the government's long-term goals to inject new impetus into the Chinese economy.

GDP growth expectations	GDP current growth	Growth expectation 12 months
USA	2.1%	2.0 – 2.5%
Europe	2.1%	2.0 – 2.5%
Switzerland	1.1%	1.0 – 1.5%
Japan	1.3%	1.5 – 2.0%
China	6.9%	6.0 – 6.5%

Go-ahead for reduction of central bank balance sheets

In the absence of any external shock, we assume that the US Federal Reserve will continue its careful policy of raising interest rates. More important than the key interest rate, however, should be the decision to begin the announced reduction of the Fed's balance sheet. We expect the program to be started during the second half of the year. The Federal Reserve communicated its reduction plans in advance, and market reactions have so far been imperceptible. Much remains unclear at the moment, including to what degree the balance sheet can be decreased as well as how high the new debt load will become under the Trump government. Whether the reduction will really happen in the end without so much as a whimper depends on whether the additional offer of bonds finds sufficient demand. If not, a price adjustment threatens. Demand will depend greatly on future inflation expectations, and the views on this vary. If economic models are to be believed, salary growth and inflation will increase within the current economic climate. Technological advances (automation), an ageing society, and high debt, however, cast doubt on such models, which is reflected in the current low market expecta-

Interest rate expectations	3-m rate (Libor)	Expectation in 3 – 6 m	10-year swap	Expectation in 3 – 6 m
USA	1.3%	slightly higher	2.1%	rising
Europe (D)	-0.4%	stable	0.8%	rising
Switzerland	-0.7%	stable	0.2%	rising
Japan	-0.0%	stable	0.2%	unchanged

Data by August 24th, 2017

tions for future inflation. We believe that the truth on this point also lies somewhere in between. Should the market be surprised by higher inflation figures, this could have a significant effect on the demand for bonds and the interest curve. Nevertheless, fixed-income investments are unattractive for more reasons than just their potential risks. When viewed in absolute terms, current yields are also less interesting (see upper section on page 7).
In Europe, we except no changes to interest rates in the foreseeable future. Inflation pressure has been lessened with the recently strengthened EUR, which is why the ECB will most likely only slowly reduce its bond purchasing. As a result, interest rates in Europe remain (far too) low, especially in countries with a healthy economy, such as Germany.
Switzerland will just have to paddle along in the ECB's wake. We do not expect that anything will change in this regard, at least not before the ECB decides to act. China will continue to attempt to control its economy through lending and convert short-term loans into longer-term ones.

Stock markets – still en vogue

The positive trend on the stock markets appears to be continuing. The gains during recent months were at times accompanied by significant profit increases for companies. Over the next 12 months, the comparison will be somewhat more challenging due to the increased base and at times already high expectations. In a relative value comparison, the markets outside of the USA still contain some catch-up potential, which is why we prefer these in general. Despite some higher valuations, stocks in the current low-interest environment appear to be the most attractive asset class, at least from a relative viewpoint. This applies particularly to Swiss stocks, which still generate comparatively high returns and, depending on their segment, benefit from a stronger EUR. Market volatility sank to historic lows during the summer months. Even though market phases with a low fluctuation margin can persist for a long time and are not a good indicator for market adjustments, the price risks from stocks should not be underestimated. Notwithstanding, stocks remain the heavyweight in our allocation for the coming months.

Market	Index level	P/E	P/S	P/B	D/P	Expectation 3 – 6 m
S&P 500	2 439	18.7	2.1	3.1	2.0	sideways
DAX	12 181	13.4	0.9	1.8	2.8	rising
SMI	8 934	17.9	2.1	2.6	3.3	rising
TOPIX	1 592	13.9	0.8	1.3	2.0	rising
China H Shares	11 051	8.8	1.0	1.1	3.5	rising

Will the central banks' balance sheet reduction turn things around?



Source: Bloomberg

Data by August 24th, 2017

OVERVIEW – ASSET CLASSES

Emphasis still on stocks and regional shifts

Asset class	Positioning	Change since last investment decision
	Min. — – 0 + ++ Max.	
Bonds		
Government bonds		We are continuing to clearly underweight bonds and are focusing on short maturities; we prefer corporate and emerging market bonds; no highly indebted countries. Reduction of inflation-linked bonds. Mexican peso bond sold at a profit.
Corporate bonds		
Emerging markets		
Equities		The geographical shift from the USA to Europe goes hand in hand with a cyclical focus; expansion of industrial stocks at the expense of American pharmaceutical stocks. With the acquisition of European mid caps we remain overweighted in stocks. Among emerging markets, continued preference for China, India, Vietnam and Russia.
USA		
Europe		
Switzerland		
Japan		
Asia/Emerging markets		
Alternative investments		Added investment in selected hedge fund strategies in the global macro & event-driven segments, as well as Asian long/short equity manager. Expansion of the ILS universe with third-party funds. Exposure in a balanced portfolio: 4% gold, 1.5% silver.
Hedge funds		
Insurance-linked securities		
Raw materials incl. gold/silver		
Real estate		
Currencies		Our currency ranking: 1. XAU, EUR, GBP, NOK, SEK, EM Ccy 2. USD, CAD, AUD, CHF 3. JPY We have significantly raised our EUR exposure based on improved economic forecasts.
USD		
EUR		
CHF		
Other		

Previous Current Change

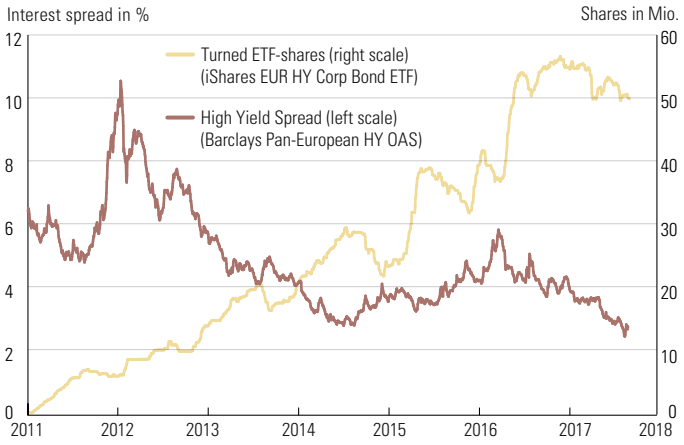
Please note:
If you would like to receive a copy of our Investment Policy publication with detailed market assessments, please contact your relationship manager or register with Nadine Vonwyl at nadine.vonwyl@reichmuthco.ch.

HIGH YIELD – "HIGH" IS ONLY THE RISK

Bubble in European credit market

Since the whatever "it takes" speech by Mario Draghi in July 2012, returns on EUR-denominated bonds have been plummeting. Since these have already been in the negative zone for a long time for top issuers, investors are increasingly turning toward bonds of lower quality in order to achieve at least a positive regular income. The returns on EUR-denominated high-yield bonds have fallen to new lows. With an increasing demand for exchange-traded funds (ETFs), investors are also investing in asset classes without worrying about the selection of the underlying securities. Whether, for example, the risk for a EUR bond from Turkiye Garantie Bankasi (Turkish bank) included in an ETF and with a measly return of 1.1% until 2019 has been adequately compensated for is questionable. The good mood could quickly shift and dry up liquidity, which could present problems for daily traded ETFs.

Cash flow in ETF muddies returns: Avoid this segment



Silvan Betschart

PENSION FUND INVESTMENTS – THE MAGIC FORMULA

Less risk and better returns thanks to tax benefits

Voluntary purchases

Voluntary and correctly structured purchases of additional pension benefits continue to offer one of the most interesting tax optimization options.

- They boost your personal pension assets and reduce taxable income on a one-to-one basis.
- The dividends and interest income received during the investment period are exempt from income tax. This is not the case for private assets, and there are also annual wealth taxes.
- Upon retirement, a reduced tax rate applies when withdrawing pension assets, which is separate from other income. A carefully staggered withdrawal of pension assets can also result in further tax benefits, depending on the canton.

Example: An additional 26% return

Depending on the canton, the marginal tax rates for a taxable income of CHF 150 000 amount to between 27% and 42%. This means that a voluntary purchase of CHF 50,000 would result in a direct tax saving of CHF 17 500 (with a marginal tax rate of 35%). If the withdrawal of capital as mentioned above is taxed at 9% (based on Lucerne), a considerable added value of 26% is achieved.

Additional advantages

By optimally structuring an individualized occupational pension plan, such as our PensFlex for supplementary insurance, you can benefit from additional advantages:

- No cross-subsidization of old-age pension
- Comprehensive rollover of investment income
- Self-determination through individual strategy selection
- Guaranteed payment of all pension assets in the event of death

Our specialists would be happy to assist you in making your decision.

Marco Danelli, Marcel Roos

A MATTER OF BUSINESS MODELS

Christof Reichmuth comments on the scale of private banks

Real private bankers – what does that mean?
The concept of "private bankers" is defined in the Swiss Banking Act and has been a protected term since 1997. It refers to a private bank whose partners carry unlimited personal liability for their bank. In our case, this is Jürg Staub, Karl Reichmuth and myself. The three of us bear unlimited liability with our private assets for the obligations of our bank.

Are you also liable for the deposit items of your clients?
No, we're liable for the obligations, essentially the money in the accounts on our balance sheet. The deposit items are special assets kept separate from the bank's balance sheet, so we aren't liable for them. The risk there is in the investments that one undertakes.

Are private bankers becoming obsolete?
Not at all, but they are becoming a rare breed. When we founded our bank, there were still 16 active private bankers. Now there are just six. The reasons for this development are tax-related, on the one hand, and size-related on the other. More specifically, there is less willingness to be utterly and completely liable for the balance sheet. We founded our bank in the form of a corporation with unlimited liable partners and thus combine the advantages of a corporation with the benefits of private banker status. And we are prepared to maintain our unlimited liability for our obligations.

Why?
Because it sends out a very strong signal. You don't recklessly offer unlimited liability, especially backed by your own private assets. It also reveals a lot about the risk awareness of the leading partners. We cultivate a careful business strategy focused on the long term. This is reflected in everything that we do and influences the entire company.

Are you worried about increasing regulations?
The tide of regulations is naturally an irritation, not just for us but for our clients as well. It is also the obvious consequence of a lack of long-term, responsible actions. In the meantime, it appears that regulatory bodies are beginning to change their views. Small and well-managed banks should have less bureaucratic and unnecessary paperwork to deal with in the future.

Do small banks have what it takes to survive then?
We tend to remain cautious in the face of increasing trends toward centralization and pressure to expand. Bigger is not necessarily better. This has been proven over and over again in the past, especially in the media coverage of large and very large banks. Depending on the business model, a bank that manages assets of CHF 1 billion can work well, while others fail with 20, 50 or even 100 billion. That's why we take statements about minimum sizes for banks with a pinch of salt and sometimes even laugh about them. Anyone who feels the urge to make generalized statements about the minimum size of a bank says more about themselves than the topic itself. It doesn't bother us, at any rate. We focus on our clients' wishes, avoid excessive complexity, and always strive to develop new and innovative ideas.

Why are private banks such as yours necessary?
Because no two individuals are the same. We recognize that people are different and that the personal situation of each client is extremely distinct. Standardized services, not to mention robots, cannot offer a suitable solution. So, private bankers are required, private bankers that listen, act discreetly, think about future generations, and behave responsibly. That is what we offer. Our clients are predominantly those who are looking for these precise qualities, whose lives are governed by the same values as ours are, and who appreciate a clear opinion about the markets. There are also clients who just find one or more ideas in our investment segment particularly attractive. "People and money in harmony" is the motto for integral investment management.

Agenda
3rd Trimester 2017

Integral circle: Pension planning
Fundamentals and optimization possibilities

Lucerne:	Sept. 6th, 5.30 am
St. Gallen:	Sept. 18th, 5.30 pm
Zurich:	Sept. 12th, 11.30 am and Sept. 14th, 5.30 pm

2018 Market Outlook: Our traditional annual outlook

Lucerne:	Nov. 20th, 5:30 pm
St. Gallen:	Nov. 13th, 5:30 pm
Zug:	Nov. 7th, 6.30 pm
Zurich:	Nov. 9th, 5:30 pm and Nov. 15th, 6:30 pm
Germany:	Nov. 23th Düsseldorf, Nov. 29th Munich

Further events that Reichmuth & Co supports or attends:

Reichmuth & Co Lecture No. 8 at the University of Lucerne with Dr. Josef Ackermann on the topic: "Destructive creation: Lessons from the financial crisis and the future of Europe" (Sept. 9th, 6:15 pm, LU)

Food for thought from the St. Galler Tagblatt newspaper with Dr. Thilo Sarrazin on "What next for the EU and the euro?" followed by a panel discussion with Christof Reichmuth (Sept. 28th, 7 pm, SG)

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