Check-Up

Reichmuth & Co Private Bankers Client Newsletter
Integral Investment Management | January 2019



Editorial

For investors, 2018 was a difficult year. The only way to find a positive note to ring in the New Year is by comparing this year's results to last year's.

We consider the current weak economic phase on the markets to be a correction rather than the extreme slump of 2000 or 2008. Such phases repeatedly occur at irregular intervals, which is why we expect 2019 to be more positive – unless the global debt problem puts a damper on what continues to be solid economic growth.

This Check-Up will tell you how we plan to strengthen the assets entrusted to us by increasing their robustness with global diversification. We wish you and your loved ones a healthy and joyous New Year.



Jürg Staub,
General Partner

GAME OVER FOR PRINTING MONEY

Is another debt crisis looming?

For the past 10 years, the central banks have been "spoiling" us with piles of newly printed money. The only unfortunate thing is that no one and no country can print its way to prosperity.

The extensive fiscal and monetary measures enacted as a reaction to the financial crisis 10 years ago saved the financial system. The aim was to limit the damage to national economies. This was the correct step, but because of those fiscal-policy bailouts, government debt in many countries – industrialised ones in particular – increased dramatically. The sole remaining alternative for stimulus was monetary policy, which became the "only game in town".

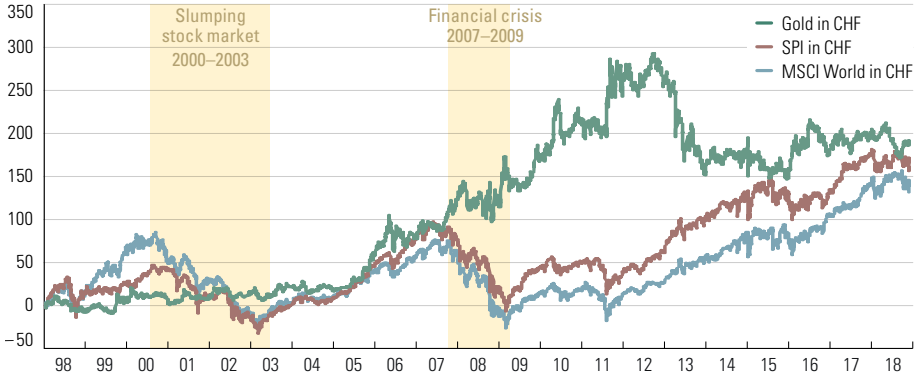
Shrinking central bank money supply

That game is now over. For the first time, sales from the enormous US Fed's bond holdings are now higher than the new purchases of European and Japanese central banks. In short, on a global level new central bank money is no longer being printed, even though monetary policy is still very expansive thanks to low interest rates. As a result, in the future the economy cannot expect a boost from either fiscal or monetary policy. Quite the opposite, in fact – and precisely now, at a point when the leading figures in world politics are not exactly exuding trustworthiness.

Are we facing a new debt crisis?

The extreme monetary policy is hardly showing any more results, except for dangerous distribution effects for democracies. A lengthy period of cheap-money policy also leads to erroneous allocations, which are usually only recognised in retrospect. They become dangerous when debt-financed bubbles appear. Real-estate bubbles are a classic example. Lower interest rates increase property values, which in turn enables more outside capital to be borrowed. At the same time, a large supply of new real estate is produced during such a low-interest phase. A point is reached in which the construction of properties outstrips the demand. The excess supply causes rents to sink. If interest rates also rise, double valuation

Continued on the next page



Source: Bloomberg

adjustments occur, such as lower rental incomes with higher discount rates. The danger of such a development is obvious in the overheated Swiss real estate market. Nevertheless, banks are now better capitalised and the largest investors such as pension funds do not have outside financing.

Debt crisis in southern Europe?

In Europe, we are seeing erroneous allocations due to monetary policy in the market for government bonds. Southern European countries, Italy in particular, are the main focus at the moment. The most probable response will be to continue cobbling together a bail-out package. Real solutions – such as how they will be set up one day with effective amortisations – will have to wait even longer.

Debt crises in the Far East?

Countries with foreign-currency debts are the usual candidates for a debt crisis. In China, however, the debts are not held by the state but rather by private individuals; in Japan, the opposite is true. Nevertheless, these debt securities are held by nationals in both countries and are therefore less dangerous.

US debt levels, a risk?

Debt levels in the USA are very high both for the government and for companies. Public debt is not a worry, because the US can print its own dollars. The issue to keep in mind here is if and how long the US Fed can retain its independence. If it cannot, investors would have to hedge their US dollars again despite the high hedging costs (interest difference).

Game over for debt-financed share buybacks

One of the reasons for the strong development on US markets was debt-financed share buybacks, where companies take on debt to buy back their own shares. This "balance optimisation" works until the interest rates on the debt become higher than the revenue from the shares. That time has now arrived. For example, McDonalds' debt has tripled in the last 10 years from USD 10 billion to 30 billion, while its equity has fallen from USD 13 billion to –3 billion due to share buybacks. With a debt of 3× EBITDA, McDonalds' debts are nevertheless still sustainable. As a precautionary measure, we are removing shares of companies that leverage their share buybacks from our recommended list.

Which investments are attractive?

Those who want to protect themselves from debt crises in advance must fulfil two criteria. Firstly, they must think in the long term, i.e. independent of benchmarks. Secondly, they must differentiate between volatility and risk in terms of definitive losses. Anyone who can do this should consistently avoid the greatest risk candidates and above all regularly assess the quality of existing investments. As the McDonalds example shows, a balance sheet can change significantly within 10 years. When it comes to equities, investors should choose companies that are able to withstand crises – those with a healthy balance sheet and sufficient equity. They can better survive a challenging cycle, since price fluctuations for them are not to be equated with permanent losses. Gold is still a good option in the face of a public debt crisis. Only gold has no counterparty risk, as J.P. Morgan said, "Gold is money, everything else is credit". Over a 20-year period, gold has displayed the best performance. There were large fluctuations, but gold was able to post gains during both of the stock market crises (see graph).

Better to have all your eggs in one basket?

No, a broadly diversified portfolio is the most sensible. From a yield perspective, money markets are unattractive; they are only attractive insofar as they can increase your ability to act. By contrast, money markets are threatened by state interventions. This situation becomes even more dangerous for debtors of weak states, because when someone is overindebted, the problem is obviously more serious for the creditor than for the debtor.

Will things improve in 2019?

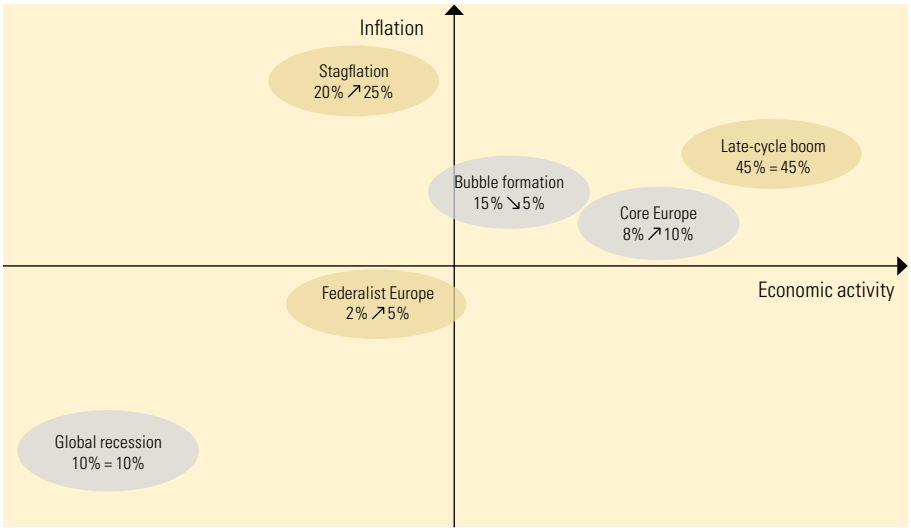
We do not see any signs yet pointing to another debt crisis, so we are forecasting a better year for investments. However, it would be unwise to forget that the day of reckoning will arrive at some point. Therefore, it is important that we talk to you personally to discuss the right investment strategy for you. There are three points in particular that deserve special attention: 1. Is the debtor quality right for the investment? 2. Quality assessment of the stock selection (see page 7) and 3. If and how much room should be given to precious metals in the portfolio. No one can foresee the future but everyone must be prepared for it. This is why we are here for you.



Christof Reichmuth, General Partner

BOOM DESPITE LIQUIDITY SHORTAGE

Economic boom no longer new, but no clear signs of recession on the horizon



Yellow = the scenarios described below

Summary

- Economy experiencing a late-cycle boom. Risks are multiplying, but growth remains solid.
- Inflationary pressure is rising, lower oil prices are a temporary help.
- Discussions about Brexit and the Italian budget are leading to new tensions in Europe.

Stagflation – Higher inflation appears desirable

Even though after the G20 summit an increase of punitive tariffs seems more unlikely, uncertainty remains high. This could put a further damper on global trade and economic growth. The number of companies that find themselves faced with rising input costs is growing. In addition, infrastructure programmes are further fuelling inflation in a tight job market. Higher budget deficits, coupled with capacity shortfalls, increase the upward pressure on inflation. In the meantime, the Fed is also quite willing to allow inflation to rise rather than throttle the current economic growth.

25%
Probability
3–6 months

Investment ideas

- Underweight shares from industrial countries
- Overweight hedge funds
- Underweight USD
- Overweight gold

Late-cycle boom – Trade deal keeps upswing going

A more reconciliatory approach in the trade dispute between the USA and China is igniting global economic growth. Tariffs are being abolished, market access is being made easier for foreign companies in China, and intellectual property is receiving increased protection. Trust is returning, and the private sector is driving new investments. During this late-cycle boom, central banks can carefully scale back their buying programmes and raise interest rates gradually. The restructuring of the Chinese economy is moving forward, with growth being shored up increasingly by private consumption. In Europe, a forward strategy is also being adopted.

45%
Probability
3–6 months

Investment ideas

- Overweight shares (more and more cyclicals)
- Avoid fixed-income investments
- Foreign currencies attractive
- Alternative, low correlated return sources such as infrastructure or ILS

Federalist Europe – Increasing uncertainty and centrifugal forces

The Eurozone is sinking into geopolitical insignificance. Different blocks are forming in Europe and adding to the polarisation effect. Italy's populist government, a less plucky Germany that does not want to pour any more money into the Eurozone, eastern European countries that want more sovereignty – in short, a poorly functioning, pan-European project. Rising interest rates in the USA are increasing pressure on the ECB, which has brought the debt problem and liability issues back to the forefront. There is no consensus in sight. Failed budget discussions in Italy or derailed Brexit negotiations are potential triggers for a "federalist Europe".

5%
Probability
3–6 months

Investment ideas

- No nominal assets from overindebted states/companies
- Gold, USD, CHF attractive

TEMPORARY ECONOMIC SLOWDOWN

Equities remain attractive



Patrick Erne,
Head of Research

Despite well utilised economic capacities and solid earnings statements, many companies are facing a stiff headwind. Rising wages and somewhat tighter US monetary policy are indications of an advanced economic cycle that has become more unpredictable due to trade barriers. However, since the threat of a global recession over the next 12 months is still very weak, it is wise to stick to one's strategy.

Slowdown, but no recession

Global economic growth peaked in 2018. The effects of the fiscal stimulus are receding gradually in the USA. Tariffs and a stronger USD should have a slight braking effect in 2019. Nevertheless, the USA is still relatively robust compared with other countries, and we are only expecting a moderate slowdown here.

The challenges in Europe are more significant. The investment climate has worsened as a result of Brexit and Italy's unsolved debt issues. Europe is also more dependent on exports, particularly to Asia. This applies equally to the Swiss economy, where some signs of a slowdown in industry and the export economy have become visible as of late. It is still unclear which direction policy in Europe is going to take, but it will most likely include temporary measures instead of lasting solutions. However, increasing credit spreads for Italy are straining the investment climate and are not conducive to growth.

Development in China should be decisive for the future course of the global economy. Since both the restructuring of the Chinese economy as a service- and consumption-oriented society and the infrastructure expansion have progressed greatly, it will be more challenging for the planners at Chinese party headquarters to achieve long-term growth targets. Nevertheless, we are confident that thanks to its largely closed market system, China will continue to have the sufficient resources and options available to guide and stimulate the economy. Should the slowdown grow more acute, we expect stronger fiscal impulses during the course of next year. Even if the geopolitical dispute between China and the USA persists for a longer time, a consensus in certain trade issues is not unthinkable and could lead to a slight upswing thanks to increased demand. For the world economy in 2019, we are expecting a weakening phase overall compared to 2018 but not a recession.

GDP growth expectations	GDP current growth	Growth expectation 2019
USA	3.0%	2.5 – 3.0%
Europe	1.6%	1.0 – 1.5%
Switzerland	2.4%	1.0 – 1.5%
Japan	0.0%	1.0 – 1.5%
China	6.5%	5.5 – 6.0%

USD bonds as an alternative

Monetary policy in the USA became somewhat tighter in 2018 with four rate hikes. Further interest rate increases are expected in 2019 as well, although the total should be lower than in 2018. Although the US Federal Reserve is raising the price of money very slowly, withdrawal symptoms are appearing on the markets. After a long period of historically low credit spreads, they are beginning to rise again, and this trend should continue in 2019. As a rule we avoid credit risks because of the sharply increased indebtedness and choose high quality only. Even though somewhat higher inflation benefits debtors, interest costs are rising due to the debt burdens that many companies, as well as governments, have accumulated over the past years. The first cautious interest rate hikes in Europe may also take place, although this would not happen until the second half of 2019 at the earliest. Over the next few months, we expect continued negative real returns in Core Europe, and bonds will remain unattractive in this region. Those who want to invest in nominal securities, however, should choose USD government bonds with short maturities over the next months. Despite a flat interest curve in the USA, we do not expect to see an inverse curve in the coming months.

Interest rate expectations	3-m rate (Libor)	Expectation in 3–6 m	10-year swap	Expectation in 3–6 m
USA	2.8%	rising	2.9%	unchanged
Europe (D)	–0.4%	stable	0.8%	unchanged
Switzerland	–0.7%	stable	0.4%	unchanged
Japan	–0.1%	stable	0.2%	unchanged

Asian markets attractive

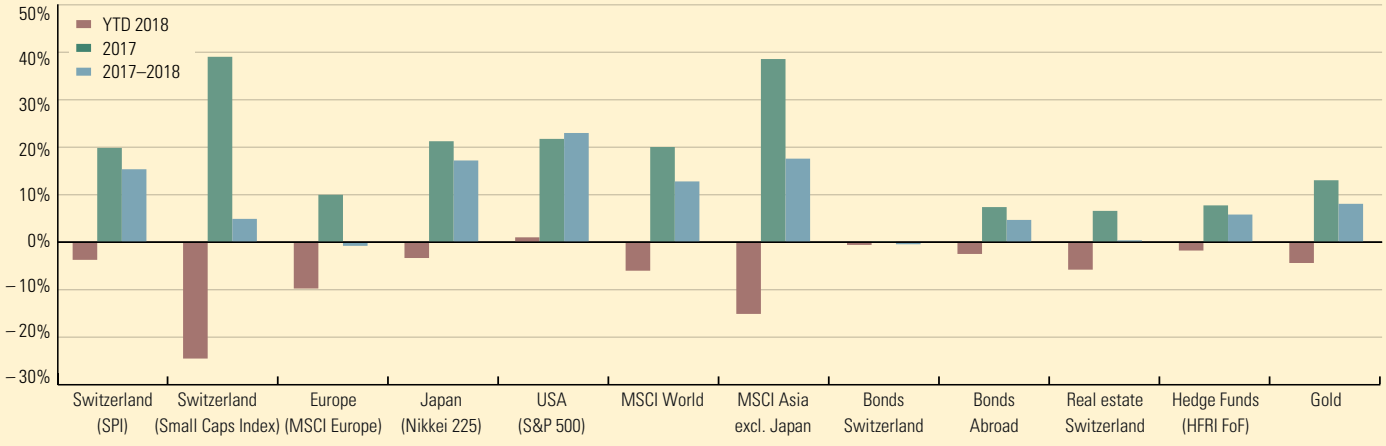
After the correction of 2018, risk premiums on stock markets in certain regions have fallen to attractive levels. This applies to China and the Dax, among others. Growth would have to stabilise and the strong phase of the USD comes to an end for a long-term bullish market in Chinese stocks. From today's perspective, we consider both these scenarios probable during the course of 2019. In the short term, however, there are already certain factors that favour Chinese stocks. The market is oversold, a negative sentiment prevails, and China has the largest share of emerging economies' ETFs, meaning it would profit from money flows from passive investors if the mood changed.

From a valuation viewpoint, the US stock market is still overpriced, despite the correction. Although there are many quality companies to be found here, the expected returns on these shares are only marginally higher than those of US treasuries – and therefore less attractive. After years of growth, there is now also a threat of more pressure on margins for US companies. Rising costs for wages should also put a damper on things. The market is expecting earnings growth of 10% in 2019 for US equities. This appears ambitious in the face of increasing costs, which is why we prefer other markets to the USA. Overall, we remain slightly overweighted in equities and favour other stock markets in Asia and Europe. We are cautious about the US equities market in general, but remain invested in certain quality shares and specialised sectors (e.g. gold mines).

Stock market	Index level (10.12.2018)	Price / earnings	Price / sales	Price / book value	Div. / yield	Expectation 3–6 months
S&P 500	2633	16.1	2.0	3.2	2.0	sideways
DAX	10622	11.8	0.8	1.5	3.4	rising
SPI	10271	16.7	1.8	1.9	3.3	sideways
TOPIX	1710	13.5	0.8	1.3	2.1	sideways
China H-Shares	10726	7.7	0.9	0.9	4.3	rising

In short

In times of strong market fluctuations, it is important to keep long-term goals in sight. To put it bluntly, 2018 was not a good year for investors – and this applied to all investment categories, unfortunately. In 2017, the opposite was true: all investments closed in positive territory. This offers little consolation for last year's investment results, but it does demonstrate that the longer the time period, the more such effects are mitigated. Or in other words, looking back over the past two years, the performance for practically all investment categories was positive.



Source: Bloomberg (as of 12.12.2018)

INVESTMENT POLICY OVERVIEW

Robust portfolio structure essential in times of increased volatility

Asset class	Positioning	A short summary:
	Min. — – 0 + ++ Max.	
Bonds		Negative real yields in Switzerland and Core Europe are the main reason for the pronounced under-weighting in this asset class. And nothing will change in this regard over the next months. We are seeing the most attractive risk-adjusted yields for US bonds. Since the US Federal Bank is still in an interest-raising mode, we prefer quality bonds with short maturities.
USA		
Europe		
Switzerland		
Emerging markets		
Equities		During the last quarter of 2018 equities across the board lost a lot of ground. We view the current fluctuations as a temporary correction and are convinced that this asset class will continue to be one of the most attractive investment options. The oversold situation in Chinese equities opens up space for a substantial counter-movement. On the highly priced US market, we are choosing quality titles with an economic tailwind.
USA		
Europe		
Switzerland		
Japan		
Asia/emerging markets		
Alternative investments		Increased uncertainty on the financial markets presents an opportunity for active, flexible macro-managers, who can profit from strong price fluctuations. In the insurance-linked sector, there exists a significant potential for re-pricing following the series of disasters in the autumn (hurricanes, wildfires). Gold is still considered a prime crisis hedge. In real estate, the cycle high point has been reached, which makes us cautious, especially with regard to the Swiss domestic market.
Hedge funds		
Insurance-linked securities		
Raw materials incl. gold/silver		
Real estate		
Currencies		For currencies, we expect medium-term development analogous to the corresponding purchasing power parities, although the USD strong phase is already very advanced. The EUR is trading at a discount, which could be reduced somewhat if things on the political front calm down.
USD		
EUR		
CHF		
Other		



If any of our clients 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.

QUALITY STOCKS: THE DECISIVE CRITERIA

Balance-sheet optimisation drives prices up. Is this a pitfall for the future?

Despite ultra-expansive monetary policy, the economic recovery phase has been lagging in the past years. Many companies exploited the low interest rates to take on cheap debt, thus optimising their balance sheets in the short term instead of investing in new projects with an eye to the future (see box). During a late-cycle phase with rising interest rates, however, the wind changes and the selection of stocks becomes more important. "Quality stocks" is a widely used phrase, but not all investors understand it to mean the same thing. What do we mean by "quality stocks"? In our view, the following criteria are key.

- **Ability to act:** The companies we invest in must be globally active and have a broad customer base. This enables them to remain flexible and not dependent on a single region. We avoid strictly regulated or state-dependent business models.

- **Products & market position:** Products have to be unique, in demand in daily life, and not easily substituted. This, coupled with a strong market position, gives a company the ability to achieve a good margin. It also offers a degree of protection against inflation in more difficult times. Furthermore, it is reflected in high, recurring cash flows, which are either returned to shareholders in the form of dividends and share buybacks or can be invested in future growth. An average yield of 4-6% can thereby be achieved.

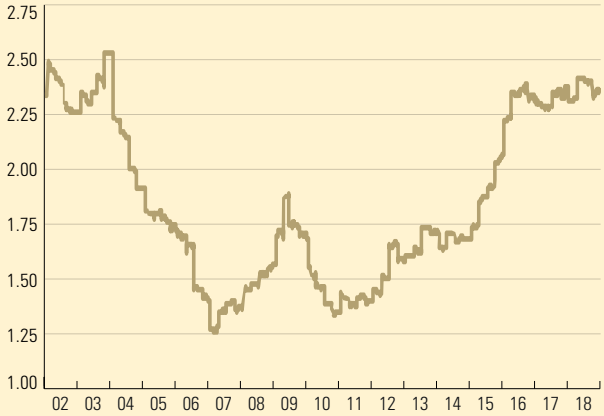
- **Balance sheet structure:** In today's environment of artificially low interest rates, particular attention should be paid to a solid balance sheet structure with a strong equity base and sustainable goodwill (no hot air). These factors give a company a solid foundation for more difficult times. Sooner or later, the current debt issue will end in a global recession or stagflation, which makes a strong balance sheet essential because it enables companies to withstand recessions and reduces their exposure to increasing interest burdens during periods of stagflation.

This is not an exhaustive list, but the criteria mentioned here are among the most important for identifying quality stocks for our recommendation list. The ranking of the criteria can vary depending on the cycle. In our Global Leaders selection process, we are currently placing a special focus on sustainable balance sheet structures. It is particularly impressive to see this strength in Swiss small cap stocks, where a large number of companies possess a net cash position.

US equities being pulled down by balance-sheet optimisation

Especially in the USA, many companies have made use of affordable interest rates in recent years to take on new debt in order to finance share buybacks. This may have resulted in positive yield growth per share for many years, but the debt ratio (see graph) was also raised. Their balance sheets are thus more exposed in the case of a downturn. With rising interest rates in the USD zone and increasing share valuations, such financial acrobatics are less and less profitable. We thus try to avoid companies whose success is based primarily on balance-sheet optimisation and less on operational excellence. Operational excellence is lasting; balance-sheet optimisation comes and goes in cycles. And during an adjustment period, it is well advised not to be exposed in this area.

S&P 500 – Net liabilities / EBITDA



Source: Macrobond, Bloomberg (as of 10.12.2018)
Excluding tech, financials and energy



Silvan Betschart
Asset Allocation and Research

Klimaneutral
Druckprodukt
ClimatePartner.com/11302-1507-1001

MARKET INTERVIEW WITH MARCEL SCHNYDER (CIO)

Less-than-encouraging 2018 – more positive outlook for 2019

After almost a decade of strong market developments – especially in the US – many stocks experienced a correction in 2018. Was this foreseeable?
No, not exactly in the way it played out, because on the one hand the economy kept growing robustly and on the other hand, the regions that saw a correction were primarily those that had been under pressure in the preceding years. However, one should always keep in mind that markets can correct themselves between 10% and 15% – especially when they already have rather ambitious valuations. The expectations for companies were high and could hardly be surpassed. This makes it crucial for investors to be prepared for negative surprises as well. We work with a variety of long-term-oriented scenarios and evaluate their probabilities on a quarterly basis. The possibility of a growth slowdown due to rising interest rates and stricter trade limits was recognised early on and also influenced our positioning.

In what way?
We reduced the strategic stock quota in December 2017 by 5% due to rising price levels and also increased cash. Additionally, we started the year with a put hedge. We have been focusing on quality and diversification in our asset classes for a long time now, and we have banned highly indebted government securities from our portfolios, with the exception of short-term US bonds.

The Highlights of 2018?
Definitely the strong demand and positive performance of our infrastructure solutions. Otherwise, only alternative investments delivered moderately positive yields: CAT bonds and hedge funds. There were a few company-specific rays of hope among stocks.

Which results were less positive?
Our regional allocation for equities was a disappointment in 2018. We believe that US equities, and US technology shares in particular, could face strong pressure due to exaggerated expectations and high valuations, so we have given a stronger weighting to regions like Europe and Asia. In addition, the latest correction for Swiss small caps has been painful, despite solid positioning and the companies' yield performances.

How do you view the current market situation: risky or offering initial investment opportunities?
Risky, if you depend on short-term investment strategies and trading ideas. Market players are insecure, dangers lurk everywhere, and companies – and above all governments – are both too opportunistic and too short-term-oriented. This is an opportunity for value-oriented investors because after a correction qualitatively solid companies can be bought at attractive prices once again. In regions with negative interest rates, there are hardly any alternatives to equities.

The best investment ideas for 2019?
Stocks in Asia and Europe. Within Asia, we prefer China, India and Vietnam. In addition to these, I find Swiss small caps attractive again after a significant correction. Beyond that, you should also strengthen your portfolio for turbulent times whenever possible. This is most successful when you prefer quality as much as possible in all your investment decisions and diversify throughout your asset classes. Apart from equities, our favourites include infrastructure investments, insurance-linked securities, gold, and selective hedge fund strategies.

What are the main risks for a sustained stock market correction?
A flare-up of the debt crisis, surprisingly sharp increases in interest rates or an escalation of the trade dispute between the USA and the rest of the world. The outlook for 2019 is positive.

Marcel Schnyder,
Chief Investment Officer

2019 Market Outlook



"Novus ordo seclorum"

- Liberal world order is in reverse gear
- Strong countries dominate their areas of interest
- Country allocation becomes more important

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