Check-Up

Reichmuth & Co Private Bankers Client Newsletter
Integral Investment Management | May 2020



Editorial

A virus proves to be *the* exogenous shock that triggers a recession. The limits of (over-)optimised supply chains became obvious very quickly. However, what this crisis means for our debt-based fiat currency will only become apparent in the longer term. Once again, enormous amounts of money are being printed out of thin air to try to lessen the shock. Will this lead to doubts and diminishing trust in money's intrinsic value? In the short term, hardly, but the likelihood has increased further.

Many things that were unthinkable previously have now happened. No one can predict the future, and any assessment of the situation will always be a snapshot. This makes it all the more important to engage with one another and fine-tune your strategy in accordance with your personal starting position.



Jürg Staub,
General Partner

STATE IMPOSED

From a health to economic to financial crisis?

"Does the flap of a butterfly's wing in Brazil set off a tornado in Texas?", asked meteorologist Edward N. Lorenz in 1972, referring to the unpredictability of long-term effects. The question remains unanswered, but today we know that an invisible virus can trigger a global economic crisis.

The coronavirus did not arrive completely unannounced. We had all heard of it as early as January, and many scoffed at China's totalitarian methods in fighting the virus. We completely underestimated the speed with which this virus would affect the world – and even more so the measures taken by governments as part of their emergency legislation. "Lockdown" – a shocking freeze put on social and economic life as we knew it! The reason given: capacity shortfalls in the healthcare sector. No government can accept a mortality rate of 1 % as some sort of predestined act of God. Although no specific therapy against Covid-19 has yet been discovered, the goal is to gain time and build up ventilator capacity. Otherwise, there is a looming threat of too many deaths in too short a time.

When will the nightmare be over?
The downside of trying to win more time is that it also prolongs the uncertainty. Everyone is hoping that treatment drugs and a vaccine for the virus will be developed quickly. In the absence of a vaccine, herd immunity is needed, which would require a 60–70 % degree of infection. Confirmed cases are about 0.3 % of the population, and even including the estimated number of unreported cases at 3 % we are still light years away from gaining protective herd immunity! Furthermore, we will most likely have to wait at least a year for a lifesaving vaccine to appear.

And what if things could be sped up?
Then we would all be happy, harbour some regrets about missed opportunities to enter the market, and rub our eyes in

Continued on the next page

disbelief at how panic-stricken governments reacted to the shock with aid packages and money-printing sprees. All at once the most shell-shocked shares would be popular again, and long-term interest rates would rise due to the colossal stimulus packages.

Will the post-coronavirus world be completely different?
Hardly. The most likely change will be the acceleration of existing developments. If anything, the crisis has reinforced the defining characteristics that separate countries and people. China's reaction is totalitarian, the USA's business-friendly, France's centralised, and Switzerland's democratic using recommendations. Everyone finds arguments to bolster their own world view. We will have to accept restrictions for a long time yet, but we will learn to live with the virus. One thing is clear: We can expect more state intervention and redistribution even after this crisis has ended.

Is a financial crisis next in line?
Financial crises arise from fundamental imbalances. In our book **Déjà-vu** (www.reichmuthco.ch/publikationen), published in 2012, we analysed the history of economic crises and identified four types of crisis:

Depression or hyperinflation?
In a depression, the main element is collapsing prices as a result of weak demand. This is precisely what the enormous stimulus packages from governments and central banks are designed to prevent. A sharp recession, yes; a depression, probably not. But could the gargantuan aid packages achieve the opposite, leading to hyperinflation? Governments want to safeguard people's salaries. This is reminiscent of 1923, when French troops occupied the Ruhr region with the aim of speeding up reparation payments by means of raw material supplies. German workers put up a passive resistance, causing the government to guarantee the payment of wages with newly printed money. More money was the "reward" for production downtime. That seldom ends well – especially when high government debt and deficits coincide with political instability. All the necessary ingredients would be on hand right now, but we have yet to see that scenario unfold.

Stagflation or a triple crisis?
A triple crisis is always connected to foreign debt and usually affects individual countries. Italy, imprisoned in a EUR corset, has been one such candidate for some time and will remain so, but is not a victim yet. Stagflation is more likely, turning into a type of repetition of the 1970s due to accommodative central bank policy. However, inflation will fall due to the economic slump. After the crisis, growth could deliver a positive surprise thanks to catch-up effects and a lower base. Of the four types of financial crisis, stagflation seems most likely in the medium term, but we are not counting on it quite yet.

Is debt relief likely?
An interesting concept would be a global "Year of the Jubilee", i.e. a Biblical year of forgiveness. Many governments are highly indebted. One could imagine the appeal: "Let's agree on debt relief; after all, no one is at fault for this virus." That, however, is wishful thinking. Much more realistically, we view this as a welcome opportunity for highly indebted companies to restructure. In the USA, the attitude toward debt is quite relaxed in general. When major financial problems arise, "Chapter 11" is an effective procedure for US companies. We therefore expect to be at the beginning of a major "distressed cycle", which we intend to capitalise on for our clients with the help of specialists.

This crisis is dangerous…
…for all companies without a viable business model; these are often young companies dependent on external financing. This crisis is also dangerous for Europe and the EUR, because nation states rather than supranational organisations have always proven to be most capable of action. International solidarity has been severely weakened by border fences and delivery blockades. This crisis is also dangerous politically, because it can be misused for the widest range of individual interests. Dirigistes and socialists view this as their chance. This is probably why we are seeing our neighbouring countries displaying strong interest in Switzerland as a prime depository location.

Can you profit from a crisis?
Hardly. It is more important to emerging as unscathed as possible and to be ready to take advantage of opportunities that may arise. The greatest opportunity for investors is the chance to secure favourable purchase prices. Of course, margins are under pressure, and we may have yet to hit the bottom. But what is the alternative? Cash? Yes, the amount you may need for the next two to three years. Bonds? Good quality ones with short to medium duration have very low returns. Shares? Yes, they are a productive capital stock. Prices can fluctuate tremendously, but this is clearly our preferred asset class in the long term. Alternative investments? Yes, our focus here is primarily on the "distressed cycle" (see p. 5). Gold? Absolutely, because there is certainly less gold being conjured up than new debt instruments or money. So what is the best recipe? The right mix depends on many factors such as your unique personal situation, world view and above all your financial goals. It is best to answer this question in a personal conversation. We are looking forward to it.

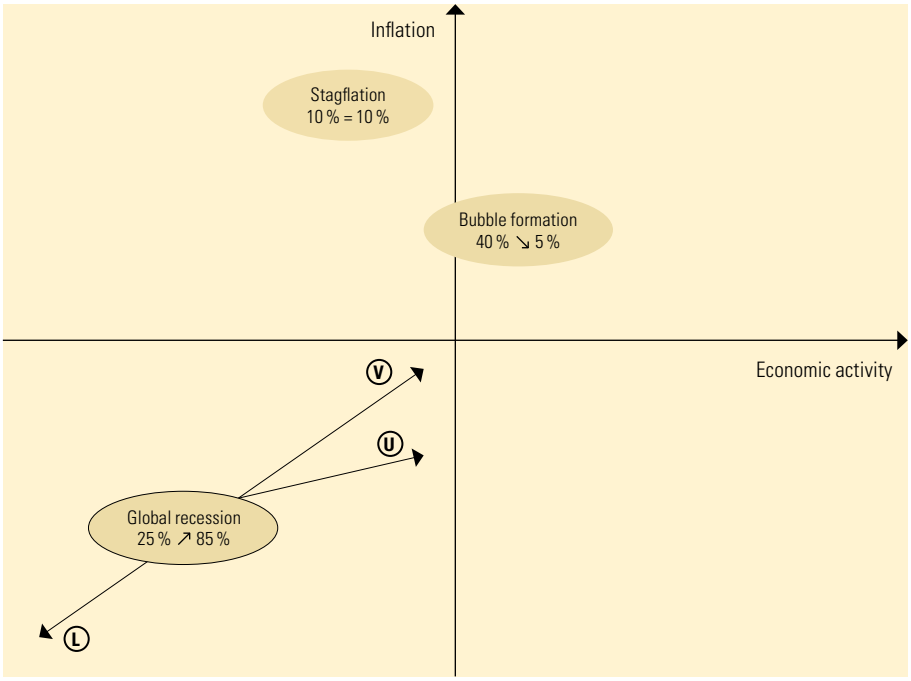


Christof Reichmuth, General Partner

OUR SCENARIOS

Silvan Betschart and Cajetan Bilgischer

The recession is here. What kind of recovery will follow – V, U or L?



Summary

- After 3–6 months, the exogenous shock forces global economy into recession with an open exit
- Temporary "liquidity crisis" the lesser of two evils
- Record expansion of monetary and fiscal policy
- The "system" is kept alive, no matter the cost
- The "treatment" of the crisis feeds long-term inflation risks

With many parts of the world in lockdown, it is inevitable that the global economy will enter a recession. The question is, how long will it last? At the moment, we are assuming that the global economy will come to a temporary standstill, which in a recessionary context would argue in favour of the "liquidity crisis" scenario with a V-shaped recovery. Nevertheless, there are two other possible outcomes to consider, namely a U-shaped or an L-shaped recovery. We are mentioning these possible additional sub-scenarios right now but assigning them a lower probability of occurrence.

Ⓥ Liquidity crisis (~50 %):
Rapid recovery of economic activity

The imposed economic standstill leads to a shortage of liquidity, not just for many companies but also for financial market participants. The former find themselves in a fight for survival and hope for government support. The latter, suffering from the exogenous shock, trigger a wave of selling on the markets and count on the support of the central banks – practically as an "established right". The liquidity squeeze can be resolved since monetary policy is now flanked by fiscal policy to an unprecedented extent. The second-round effects of the pandemic remain contained, restrictions on businesses and individuals are eased, and the way is clear for a relatively rapid recovery and return to long-term trend growth.

Ⓤ Solvency crisis (~20 %):
Loan defaults delay recovery

The virus-induced curbing of economic activity increases the insecurity of business owners, who feel threatened in their existence despite promised government support. This uncertainty is exacerbated by tensions on the oil market, where supply and demand have been thrown off balance. The massively indebted shale oil industry in the USA can no longer produce at a profit. A veritable wave of bankruptcies hits the energy sector, infecting other areas of the credit market as well. The default rate rises sharply and puts the US economy in jeopardy, making a quick recovery impossible. Stress on the financial markets remains high and rescue measures must be massively expanded.

Ⓛ Depression (~15 %):
No economic recovery

Economic pressure pushing for the early lifting of restrictions on businesses and private individuals paves the way for another wave of the pandemic, which then actually happens. The result is an extended economic downturn. Even the repeated bailouts can no longer keep the economic and social fabric together, as the effectiveness of each additional unit of "support" decreases and does not reach the real economy. All the major central banks emerge as buyers on the stock markets, and a wave of nationalisation sweeps through the private sector. No economic recovery takes hold, and a reset of the economic system in place up until now becomes imperative.

RETURN TO NORMALCY

Rapid recovery or underestimated second-round effects?



Patrick Erne,
Head of Research

The coronavirus pandemic is the exogenous shock that has plunged the global economy into an abrupt recession. Closed borders, a prescribed economic standstill and uncertainty as to how long the situation will last are all leading to a historically unprecedented sharp and rapid economic collapse. Even if the market is supported in the short term by large-scale rescue measures and the coronavirus is sooner or later brought under control, the second-round effects of these interventions are still impossible to gauge. However, the attractiveness of cashflow-producing investments and gold has increased further.

Slow economic recovery in second half of year

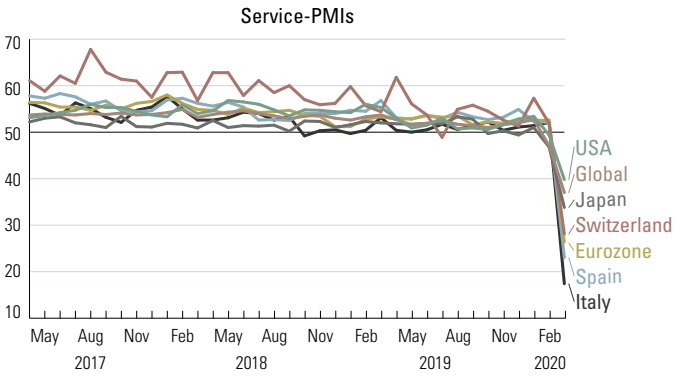
The economy has suffered a dramatic collapse over the past two months. It is showing signs of being the most severe economic slump since the Great Depression. Nevertheless, the measures taken to contain the virus and keep the healthcare system going appear to be having the necessary effect. The planning is now in place to begin loosening restrictions and returning to regular business activities, but it will probably be some time before things are back to normal. Even if there is pent-up demand in some areas, initially consumers will act cautiously, especially if they have lost their jobs during the crisis or had to accept significant wage cuts. Once the crisis is over, companies are also unlikely to immediately start hiring people or making new investments. In China, the economy has already been restarted after its standstill, and business activity is on the rise again, albeit still far removed from pre-crisis levels. However, what happens if production returns to normal but the weakened, Western consumer is not consuming? Could there be a new demand shock waiting in the wings? The second-round effects are difficult to predict. Nevertheless, we expect the recovery to begin as early as the third quarter, although it will take several quarters before pre-crisis growth is achieved once again.

Each region has its own challenges. In real economic terms, we consider emerging countries in Asia with a rapidly growing middle class to have the best prospects. In Europe, each country is following its own path in battling the crisis. Whereas Switzerland and Germany have plenty of fiscal policy leeway, other countries are dependent on external support. Finding a forward-looking solution for this problem within a reasonable period of time remains an immense challenge and could endanger the recovery in Europe.

Attractive risk premiums on the credit market

The resulting liquidity crisis on the financial markets has prompted the US Federal Reserve to intervene in practically all segments of the credit market, including, among others, non-investment grade corporate bonds. This should stabilise and slowly normalise risk premiums, which have risen to crisis levels in all segments of the credit sector. In the area of corporate bonds, this has enabled the yield outlook to become attractive again despite lower interest rates – even for investment grade bonds with low default risk. In the high-yield segment, as well as in emerging market bonds and the securitised credit market, the higher default risk is currently compensated with attractive premiums. However, selection is all the more important here, which is why we recommend working with specialists in these segments (see also box on p. 5).

Service sector in drastic slump



Source: Bloomberg (as of 15.04.2020)

Underestimated risk of inflation?

Monetary and fiscal policy is firing from all cylinders to soften the economic consequences of the lockdown. How long this all-encompassing support will continue after the pandemic has been overcome is a very different and sensitive political question. If economic confidence returns and consumer and investment behaviour recovers, some of this liquidity could quickly return to the market and result in another strong surge in assets. Should this development lead to raw materials becoming more expensive as well, the price increases will also be felt in the real economy. Very expensive government bonds in particular would be unattractive in this environment, since there is no chance of real value retention with the current low interest rates – even with

only gradually rising inflation. So, for those who have to hold bonds, we recommend inflation-linked bonds over nominal bonds. The crisis has also narrowed the interest rate differential against the USD. Due to the potent mix of rapidly growing budget deficits and an exploding central bank balance sheet, we have become more cautious about the USD and recommend reducing the allocation. In our opinion, gold is the sole remaining "hard currency" that cannot be printed arbitrarily and thus remains an indispensable portfolio component, despite recent price increases.

Cashflow is King

The attractiveness of stocks in our main scenario remains high in general since the cashflow or dividend yield is set in relation to interest rates for share valuation. Of course, both indicators have fallen since the outbreak of the pandemic. In the aftermath of the crisis, however, interest rates are likely to remain low for some time, while cashflows for many quality companies should recover quickly. This applies especially to companies with a business model that also performs in times of crisis and generates positive cashflows. These are mainly found in the healthcare and consumer staples sectors, but an increasing number of technology and software companies now belong to this group as well. Thanks to solid cashflows, these companies are able to finance future growth themselves, not to mention possess healthy balance sheets and distribute an attractive dividend to shareholders.

Avoid structural losers

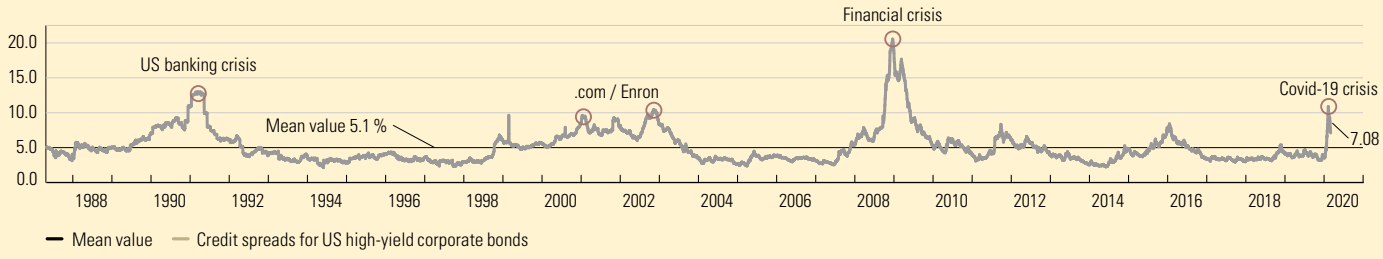
Depending on your risk appetite, we recommend adding quality stocks with a somewhat more cyclical business model to your equity portfolio. Many of these stocks have been severely punished during the market correction and are now trading at very favourable valuations when earnings are viewed as normalised. Even though the business model is being directly affected by the coronavirus crisis, earnings should recover quickly once the pandemic is over, and they have high upside potential. Since it is difficult to predict when the recovery will begin, the main focus is on the company's balance sheet. It should not be overextended to ensure that the company does not become dependent on lenders. Not every business will survive this crisis. Certain industries were already facing a structural headwind before the pandemic struck. The crisis will further consolidate some of the existing trends, e.g. in the area of digitalisation. The use of homeoffices, video conferencing and online shopping will most likely continue to expand even after the crisis, and certain sub-sectors will face significant challenges. Active selection and differentiation between cyclical and structural losers is essential – particularly in difficult times.

Investment idea

New distressed cycle?

The policy of low interest rates in place since the last financial crisis has tempted many companies to borrow cheaply and buy back their own shares at all-time highs. With the abrupt onset of this recession, many companies are now experiencing severe payment difficulties as earnings fall, rating agencies lower their outlooks, and the suddenly risk-averse financial investors in the credit markets are now demanding high risk premiums. Debt restructuring will be unavoidable for the majority. In the current crisis as well, the high risk premiums indicate a sharp rise in default rates (see chart).

Attractive risk premiums on the credit market



Source: Bloomberg (as of 15.04.2020)

Anyone who has sufficient capital and applies a long-term and anti-cyclical approach can take advantage of this situation and buy in to companies at favourable prices. Distressed managers are acquiring corporate debt on the market at high discounts to nominal value, opening bankruptcy proceedings as a member of the credit committee, and restructuring the corporate debt. This often happens by writing off a portion of the debt and converting it into new equity. Existing shareholders forfeit their claim to the debt investors, who then participate in the recovery of the company as new owners. The USA in particular has an established process for this in the form of "Chapter 11", which enables relatively fast debt restructuring. In phases with high risk premiums, "distressed strategies" offer above-average yield opportunities in the succeeding years. Together with selected managers, we have been successfully implementing this type of strategy for more than 20 years.

ASSET ALLOCATION

Cajetan Bilgischer

High home bias – scepticism toward Europe and USA – positive for Asia

Liquidity



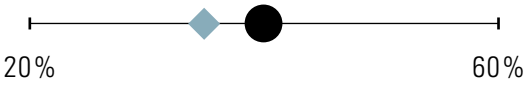
Our liquidity buffer has decreased as we took advantage of opportunities during periods of market stress.

Bonds



With their massive bond purchase programmes, the Fed and the ECB have effectively put a floor under the prices for investment-grade corporate bonds from their respective countries. We remain focused on quality bonds with a moderate default risk.

Shares



Switzerland	=
Europe	–
USA	–
Emerging economies	=

When the drastic pandemic measures were initiated, the need for liquidity meant that everything was initially disposed of. Only towards the end of the quarter did the wheat separate from the chaff. Securities selection became essential. We consider our favourites, which definitely include solid dividend stocks and global leaders, well equipped to withstand the current turbulence. We remain committed to a high home bias and recognise long-term opportunities in China.

Real estate



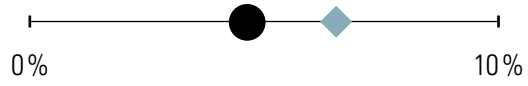
In the current phase, the selection of sub-segments is also decisive for real estate. Operators of logistics properties and data centres are of interest. Regionally, we clearly prefer Asia in addition to our home market.

Alternative investments



With its massive distortions, the volatile financial market environment offers opportunities for active and flexible hedge fund managers. In addition to merger arbitrage strategies and long/short credit, we consider the distressed area to be promising.

Gold



As the only real "hard currency", gold is profiting from the current monetary and fiscal policy experiments being carried out. Although at the beginning of the correction the precious metal suffered from widespread liquidity shortages and as a result was subject to a massive sell-off, the long-term upward trend remains intact.

● Our strategy's neutral position ◇ Current weighting

Our clients can request our detailed investment policy with thorough market estimates from their client relationship manager or register for it themselves by contacting nadine.vonwyl@reichmuthco.ch.

OPPORTUNITIES WAITING TO BE SEIZED

What you need to consider now

"Never let a good crisis go to waste" was a saying of the former British prime minister Winston Churchill. Here is a selection of concrete ideas:

Buy (additional) shares now?
The longer the investment horizon and the greater the fluctuation tolerance, the more attractive the securities in these three groups are looking to us:

- **Global leaders:** Companies that rank among the market leaders in their industries and whose business models are comparatively less affected by the pandemic. These include companies from defensive sectors such as pharmaceuticals or consumer staples, and which stand out thanks to high, relatively secure yields in the current low interest rate environment.
- **Growth stocks:** These are quality stocks from companies in structurally expanding market segments. Due to the high margins, these companies are usually very profitable and as a result have enjoyed high valuations in recent years. Now, after a long period, some of these shares are once again available at reasonable prices.
- **Bottom fishing:** These are more cyclical and economically sensitive stocks, which were hit especially hard by the virus-related economic downturn. Measured against "normalised" earnings, these stocks are now at bargain prices and may rise substantially in a recovery scenario. In the current environment, however, particular attention should be paid to the soundness of balance sheets.

How am I invested at the moment?
If your current stock quota already corresponds to your target quota, we would recommend considering the following:

- **Improve quality:** The market at large usually corrects in a crisis. It is therefore necessary to sift through the individual investments in your portfolio according to criteria such as debt financing, margin strength, management, etc. It can be worth your while to switch from a poor-quality stock to a better-quality one – above all if they have both previously undergone similar corrections.
- **Diversification:** Alternative investments such as gold, agrarian country hedge funds, infrastructure, etc., can help to stabilise your portfolio, especially during volatile market phases. The latest turbulence offers hedge fund managers tremendous opportunities that can often only be tapped with special instruments and market access. In our opinion, gold also continues to be attractive.
- **Bonds:** Whereas more than 80% of the Swiss bond index components recently showed negative returns on maturity, the picture has changed with the crisis, and there are now isolated opportunities. We also see this trend in new issues from good borrowers who are borrowing money at short notice due to the current liquidity crisis.
- **Become more agile:** Investors whose risk capacity and risk appetite have so far led them to pursue a rather defensive strategy may now have the chance to take a more dynamic approach. Insofar as your individual starting position allows, switching to a strategy with a higher equity weighting is worth considering. Our modular concepts, among other options, are also well designed for this purpose. They implement the individual asset classes with both internal and external funds, enabling you to utilise economies of scale while at the same time quickly increasing or decreasing risks as needed.

From an integral viewpoint
When looking beyond your investment portfolio, you need to consider:

- **Prefer pension benefit purchases**
  If you are planning a tax-privileged purchase of pension benefits in 2020, it may be worthwhile to implement it now and take advantage of the lower prices – following the recent correction – for the assets. The same applies to the third pillar.
- **Review your liquidity planning**
  After such turbulent times, it is advisable to analyse and, if necessary, adjust your liquidity planning. Start by taking into account current circumstances and evaluating whether new scope could possibly be created to enable you to take advantage of today's opportunities with additional investment capital. Our financial planners would be more than happy to assist you with these adjustments.

"People and money in harmony" has always been our motto. There is a wide range of levels to work from to achieve the optimal orientation for you. We have only outlined a selection of them here. We are always available to discuss these and other possibilities with you and then tailor them to match your personal starting position. We look forward to hearing from you!



Urs J. Beck
Partner and Zurich branch manager

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"NOT THE FIRST CRISIS"

Interview with Remy Reichmuth about the current situation

What has been happening during the first few months of 2020?
January is always a busy month with lots of annual reports. It was a pleasure to prepare them since the 2019 investment year delivered very satisfactory results. Then things took a different course in February. Naturally, we were following the development of the coronavirus in China, but the reports from Lombardy were dramatic. The markets crashed almost immediately. Computer-based strategies and margin calls only intensified the correction, as did most likely those passive investors who buy up the entire index in such phases and no longer differentiate between higher and lower quality stocks.

In the meantime, the Swiss stock market has dropped 25 % from its highest level.
That is, after it succeeded in growing around 200 % since the end of 2008. The collapse is manageable over the long term – especially if you compare it to the negative interest rate environment for nominal assets. Equities remain one of the most attractive asset classes. Adding alternative investments such as gold, infrastructure, hedge funds or even insurance-linked securities help to diversify your portfolio and make it more robust. This is one of the reasons why our corporate strategy has suffered less in comparison with others.

How have clients reacted to the market turbulence?
No one is happy to see negative share price development in their portfolio. However, based on the headlines, many clients expected the losses to be higher than the ones actually reported. The majority remained calm; after all, it's not the first crisis for many of them. Especially in turbulent phases, it's crucial not to lose sight of your strategy's long-term goal. There are also clients who were waiting for the opportunity to buy in at attractive prices. They can see entry opportunities now.

How have you adjusted your organisation in light of the current situation?
We had to convene our crisis committee, which has two objectives. Firstly, to keep operations fully functional for clients and markets, and secondly, to protect everyone involved – clients, business partners, employees, etc. – to the greatest degree possible. So, we activated and refined our pandemic plan with different steps. We are implementing the measures provided by the federal government and have reorganised our office set-up in the teams to allow for physical distancing for individual employees. More than half of our staff are working from home. These organisational adjustments were carried out quickly and relatively smoothly – and almost unnoticed by our clients, which really pleased me.

What is it like to be personally liable in such uncertain times?
Our structure as an owner-managed family business with unlimited liability encourages personal responsibility in general and ensures that we do not try our hand at experimenting. The result of this approach, which is of central importance, is that we always have risks under control. That's why as a bank we don't operate a commercial lending business, for example, which could have been a risk in the current environment. We focus on those activities through which we can offer added value. This also protects against dispersal. We have also given our bank a very solid foundation. As an example, we have far exceeded the capital adequacy requirements of the banking supervisory authorities for years now.

What is your advice for our readers?
Our team is in close contact with clients and is assisting them in aligning their personal asset goals with the current environment. Any readers who have not yet been in direct contact with us are more than welcome to call me! After the recent upheavals, there are many opportunities that provide added value.



Remy Reichmuth, General Partner

Coming up

Wissens-WERT
Pension fund information (in German only) from Reichmuth & Co

Business owners report on their experiences: Featuring Zur Rose Group AG, Mövenpick-Gruppe, Ärzte-Treuhand Finanz AG, Marigin Tierklinik and Krucker Partner AG

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