# CHECK-UP

May 2021
Client information
Reichmuth & Co Private Bankers

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## A new start

The current bickering over vaccines is true to form for Europe. With an overdose of bureaucracy, we are fighting about distribution instead of production. The creation of wealth is secondary – ultimately, every pie must be baked before you can divide it into slices. In Asia, there has been a completely different focus. Here in Europe we will also hopefully soon shift away from debt-financed distribution programmes and move back towards a forward-looking recovery.

The overall situation instead seems to be pointing to further government intervention, which will have an impact on expectations for interest rates and inflation. We foresee this new environment as being even more challenging than before, meaning that an integral view of your personal asset situation will be indispensable to skilfully navigate what lies ahead. It should give rise to interesting conversations – and we look forward to them.



**Remy Reichmuth**
General Partner

# A 1970s remake?



**A year ago, the ubiquitous empty motorways made one think of the oil crisis in the 1970s. This time, however, it was the government's response to the coronavirus pandemic that cleared the roads.**

In the 1970s, many countries – and the USA in particular – responded with state-led demand programmes and expansive monetary policy. The oil crisis was monetised, except in Switzerland and Germany. This resulted in a strong inflationary trend in the USA coupled with significant depreciation of the US dollar against the CHF and the DEM. During the coronavirus crisis, all countries have chosen this route. All of them? Not quite. All the Western countries have; the only exceptions to be found are in Asia.

**US economy at full speed**
Everyone's talking about it. When it comes to how the economy is doing,

the coronavirus crisis is practically old hat. A recovery-driven boom is emerging. And in the USA, the economy is set to fire on all four cylinders thanks to government infrastructure programmes. The fact that the previous Federal Reserve Chair Janet Yellen is now Treasury Secretary fits in well with this agenda. The US Federal Reserve has clearly put itself at the service of the government.

**Green wave in Europe**

With the recent publication of "A Global Green Deal", top EU and EIB officials (von der Leyen, Hoyer) are seeking European leadership on this issue. The current mood and the upcoming elections in Germany are giving them a boost. The Greens are likely to set the agenda in the most important EU country. Even if they only become the second-largest party, their policy programme will define the direction of travel. The Greens are proponents of a full EU community of liability. They also want to ease off the debt brakes by distinguishing between public debt for consumption and public debt for investment. With this strategy, they hope to be able to fund the major generational issue of combating climate change by restructuring the economy towards $CO_2$ neutrality, despite high government deficits.

> **"The main impact of inflation is a lower price-to-earnings ratio."**

**Unlimited borrowing?**

Ever since the financial crisis, people seem to believe that there is no longer any limit to government debt. Yet who has funded all that debt? The bulk of it was acquired with the central banks' bond purchases on the open market shortly after they were issued in exchange for newly printed money. The new money was then saved or invested. Questions arise when it comes to the monetisation of the coronavirus pandemic. What happens if the current rising inflation due to pent-up demand is not a temporary phenomenon? What happens if governments continue to take on debt to fund their programmes and stimulus packages and inflation figures remain stubbornly above 2 or even 3%? Who will buy these bonds – and at what price? Can the central banks simply continue to operate like this? If they do, their argument of fighting deflation would go up in smoke. And if they stop buying, then who will buy them?

**What interest rate are investors demanding?**

Interest rates are meant to compensate investors for the uncertainties related to inflation, time horizons, default risk, etc. Short-term interest rates are controlled by central banks and remain low. The long-term interest rate is normally set by the market, a price-determining mechanism in itself. Ever since the financial crisis, however, interest rates have been skewed by the central banks' purchase programmes. If they can no longer keep this up for fear of losing public confidence, at what interest rate will investors be motivated to invest? If we have to reckon with an average of 2–3% inflation in the US, then US government bonds would most likely only become attractive again at interest rates of around 4%. That would be bad news for both bond and stock markets.

**Why does inflation pose a danger?**

Historically, inflation has had little influence on profit or dividend growth. The main influence was always in the multiplier, i.e. the price/earnings ratio (P/E). The more uncertain the future, the lower it would be. And inflation increases uncertainty for many planning variables.

**So who still wants price stability?**

The US wants maximum employment, places less of a priority on monetary stability and none at all on the exchange rate. Europe wants to keep the EU and the EUR together and is teetering towards a "community of liability". China is working on its position as a global power, but cannot permit any inflation as that would pose a danger for the Communist Party. There is one central bank that has maintained a truly credible focus on price stability: the Swiss National Bank (SNB). An EU "community of liability" would eliminate the risks of a EUR break-up for the foreseeable future – good news for the SNB, not such good news for German taxpayers.

**Preparing portfolios for a new phase**

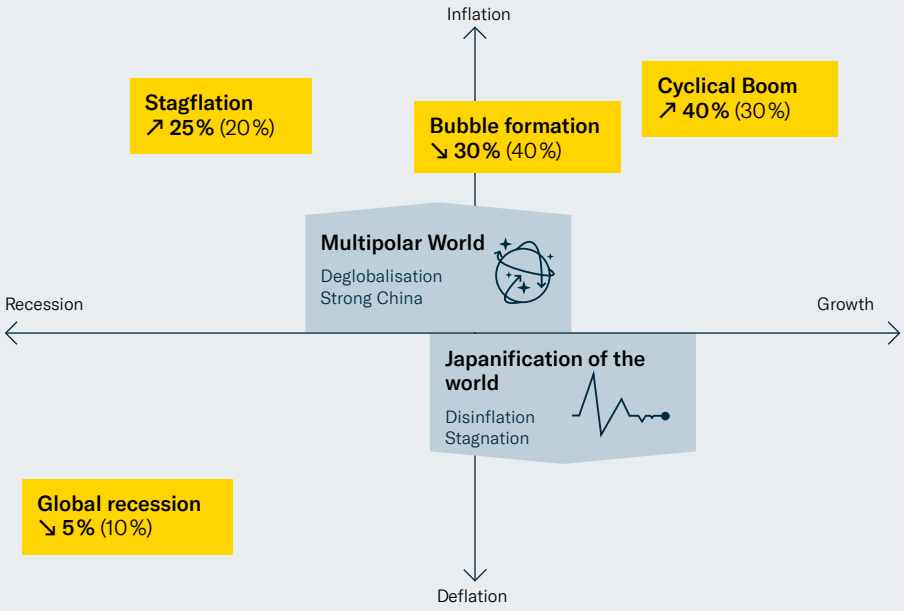
In other words, we are planning for a world in which the economy runs smoothly, where both interest rates and inflation go up. Not today or tomorrow, but the day after tomorrow. And investment strategies must be geared to this new reality. Let me end with a fitting anecdote. In the 1970s, people were still lending money to the US government, although no longer in its own currency, the USD. The USA was forced to borrow in CHF and DEM at that time. This is something that is usually common for emerging markets. Who knows, maybe a remake is in the making...



**Christof Reichmuth**
General Partner

# Our considered scenarios

The US economic motor is regaining its former poise.




**Current assessment**

- The global economic recovery is picking up speed, but not at the same rate everywhere
- Inflation concerns are exaggerated, at least for now
- Vaccine progress in the US is boosting consumer confidence and satisfying pent-up demand
- Exorbitant support measures are fuelling the investment boom

Scenarios  Underlying trends  Estimated probability of occurrence (value from last publication)

In Focus: Cyclical boom

## Successful vaccination campaigns pave the way

The end of the pandemic appears more tangible as vaccination efforts progress. Cyclical tailwinds give business leaders and investors spring fever, but this spring will not be the same for everyone. China overcame the pandemic a long time ago and is already back on track in terms of economic development. In Europe, meanwhile, a return to growth is still far in the future. The USA is confirming its resilience and, together with China, is now presenting itself as an independent global economic motor. The monetary and fiscal policy measures that were implemented supported growth, but do not (yet) pose a risk of out-of-control inflation. Consequently, the US Federal Reserve can continue to exercise patience before having to threaten the stock market with potential interest rate hikes.

**Investment ideas**

- Overweight equities (prefer cyclicals)
- Pandemic losers (energy & travel)
- (US) Infrastructure assets
- Long-term commodity asset

OUT-OF-THE-BOX

## Revival of the Roaring Twenties

Contrary to conventional expectations, economic growth will remain strong for years to come. Vaccination progress is releasing pent-up demand, and greater planning certainty is leading to a new investment cycle with parallel strong credit growth. Cheap credit and the rapid achievement of full employment are supporting consumption. Strong economic growth is accompanied by a rise in inflation, which can nevertheless be kept in check thanks to technological progress. This is reminiscent of the 1920s, an impressive period marked by great technological and scientific advances (e.g. the expansion of electrification and the widespread use of mass production).

**Investment ideas**

- Underweight nominal values
- Equities from high-growth segments, megatrends
- New technologies – invest in start-ups

Cajetan Bilgischer and Silvan Betschart

# Cyclical boom

## Is the real economy actually at risk of overheating?

**Vaccination coverage is making headway. If the vaccines prove effective against new variants of the mutating virus, nothing will stand in the way of a rapid reopening of the economy. Growth expectations have risen for 2021, and a global boom with high growth rates is gathering speed.**

### Strong growth expected

In contrast to many economic slumps in the past, consumers in general have weathered the crisis well this time and have even been able to squirrel away some savings. The savings rate has increased as a result of reduced consumption due to pandemic restrictions, but also thanks to various forms of government support. When the economy reopens completely, a substantial part of these savings is likely to find its way back into consumption and services. If the savings rate returns to normal over the next two years, growth could even exceed the already high expectations, especially in the US.

### Rising prices

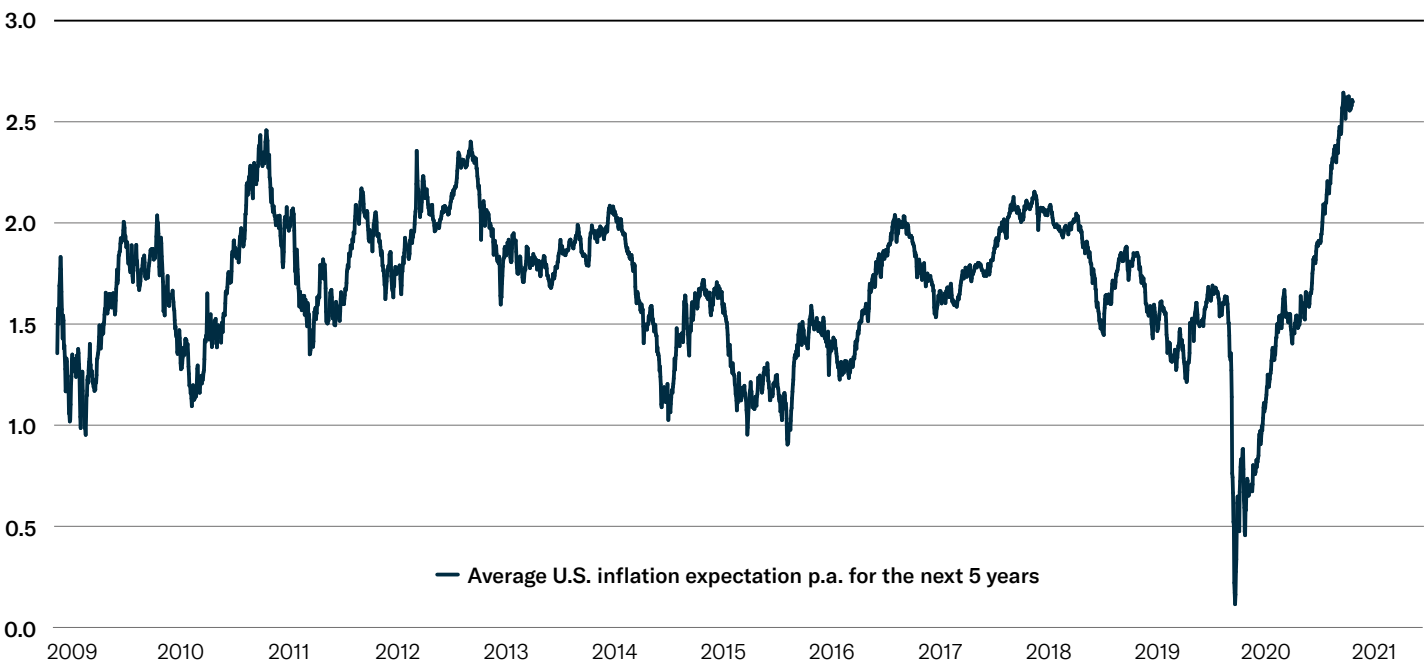
Many of us find ourselves longing for holidays abroad or a relaxed evening at a restaurant. If this pent-up demand is released all at once and encounters a limited supply, then prices will rise. That flight to Spain could cost significantly more than it did before the pandemic. In some sectors, prices have already risen substantially as supply has not been able to keep up with the rapid increase in demand. These include such things as freight rates for container ships, prices for specialised computer and computing chips, and steel prices. The question is whether prices will rise to this extent every year or if these are just temporary price increases until demand and supply have regained equilibrium.

### Inflation hump in the coming months

In the services sector in particular, barriers to entry are often low and competition is correspondingly fierce. As a result, the price increases that would be expected due to the exceptional demand should be short-lived and quickly return to normal. Therefore, we are expecting a temporary increase in inflation in 2021, known as an inflation hump.

**“Historically, an environment of strong growth and rising inflation expectations has been positive for equities.”**

RISING INFLATION EXPECTATIONS




Source: Macrobond, Bloomberg (as of 16.04.2021)

Whether or not we transition into a sustained higher inflation regime depends largely on the labour market and wage growth. If the labour market reaches full employment, then wages could also rise. However, even with a strong recovery, it will take some time before labour markets really dry up.

**Positive outlook for equity markets**
From a historical viewpoint, an environment of strong growth and rising inflation expectations that have not exceeded the 3% threshold has been a positive one for equities. With the cyclical upturn, we expect rates to rise at the long end of the yield curve. This should encourage further portfolio shifts from quality bonds to equities. If inflation exceeds current forecasts, temporary setbacks on stock markets must be expected. However, as long as growth expectations are met and monetary policy remains expansionary, stock markets should quickly recover. The situation will only become critical for equities when rising inflation and interest rate expectations start to weigh on growth. If rising inflation combines with stagnating growth (stagflation), it could not only punish bond, but also cause ructions on stock markets. However, a broadly supported global cyclical boom remains our main scenario for the coming months.

**Structural growth topics**
Growth companies active in structural megatrends remain important portfolio components. Many of these growth stocks lagged the overall market in the first four months. Even if many of these companies benefit less from a reopening of the economy, their long-term growth prospects remain above average. We continue to favour companies that are active in current trends such as digital payment systems, alternative energy, or innovation in the health sector. Some stocks have corrected slightly during the sector rotation of the past weeks and are potentially attractive acquisitions (e.g. FIS, Orsted, RWE, as well as the biotech segment). On a regional level, we continue to see the greatest growth potential in Asia. In the fixed-income segment as well, Chinese bonds are one of the few alternatives still promising positive real yields. We would use price corrections in these markets to expand long-term exposure. Even though we prefer cyclical stocks over the next few weeks, it is important to create a balanced portfolio mix of cyclically sensitive and structural growth stocks for 2021.



**Patrick Erne**
Head of Research

# Investments for an inflationary environment

Despite a temporary inflation hump, the extreme spending boom in the US with colossal infrastructure projects should help inflation expectations to rise in the medium term. Demographic shifts could also accentuate labour shortages in the coming years and trigger wage inflation. These developments could supersede dominant structural trends such as globalisation and digitalisation and result in a sustained higher inflation regime. Which investment ideas would best match a higher inflation environment?

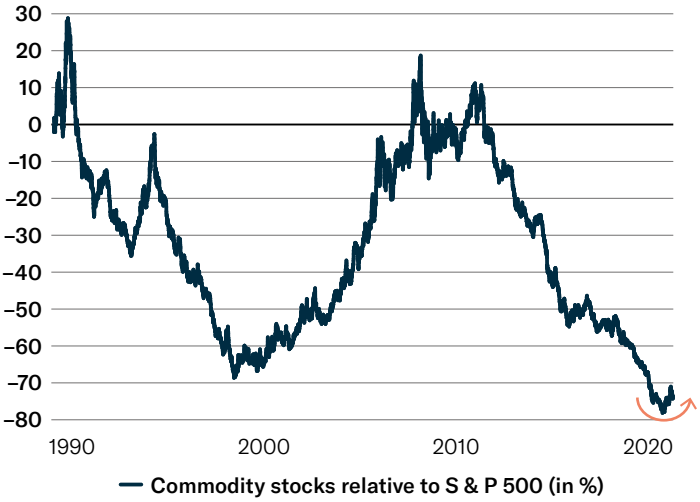
- Value stocks perform better than growth stocks during inflationary phases. As long as inflation expectations keep rising, value stocks are likely to beat growth stocks.
- Commodity stocks have historically outperformed the overall market during inflationary periods (see article on page 6).
- Precious metals are a key diversifier, especially in the event of a loss of confidence in monetary policy.
- Alternative investments also offer attractive opportunities. Inflation favours the recovery value of defaulted loans and helps distressed managers. Trading-focused strategies benefit from new, emerging trends such as interest rate hikes or rising commodity prices.
- For those who can invest in illiquid assets, investments in farmland or infrastructure are a good option (see page 8).
- Quality bonds are unsuitable for long-term value preservation in an inflationary environment.

# Commodity stock comeback

## Is a new supercycle ahead?

**Commodity stocks have fallen out of favour with investors over the past decade. A global spending boom by governments to build infrastructure and alternative energy sources, years of underinvestment in new commodity projects, and their role in a portfolio as a hedge against inflation could propel the sector towards a sustainable revival.**

CATCH-UP POTENTIAL IN VALUE ROTATION




Source: Macrobond, Bloomberg (as of 16.04.2021)

### Long commodity cycles

Commodity stocks are known for their long cycles. The last commodity supercycle began 20 years ago with the rise of China and lasted until the financial crisis of 2007–2008. Over the last decade, marked as it was by digitalisation and automation, commodity stocks have underperformed the market as a whole by more than 70%, as seen in the chart above. With the emerging boom in demand as economies begin to reopen, commodity prices – and commodity stocks as a result – have already risen a little. We expect this rotation into value stocks, which include commodity producers, to become more pronounced in the coming months. However, there are also good reasons to believe that this is not just a cyclical recovery, but rather that we are at the beginning of a new multi-year supercycle. With the massive expansion of green energy sources fuelled by record stimulus packages from the US and Europe, a sustained and robust increase in demand for specific commodities such as copper and silver, along with lithium, magnesium and cobalt, is likely. The green revolution will only be possible with these commodities.

### Supply shortages

Supply of raw materials is inelastic. For example, it can take longer than ten years after discovering deposits to begin actual production at a new copper mine. Due to underinvestment during the past decade, an investment boom in infrastructure will inevitably lead to supply shortages and price increases. A prolonged supply-demand imbalance is a characteristic of a supercycle, and the signs are all there that this imbalance will define the next few years. In many segments, it is becoming clear that the exploration for new resources is associated with investments in increasingly challenging and dangerous geographic areas, with the related costs growing exponentially.

### Commodity stocks as inflation hedge

In times of rising inflation, commodity stocks offer a degree of inflation protection and positive diversification effects. Commodity stocks are typically among the healthier sectors in today's inflation environment, where we see inflation rising slightly from a low baseline. However, commodity stocks have also shown in the past that they can still generate positive returns in a highly inflationary environment when the broader equity market is posting losses. Commodities are also traded in USD. A weaker USD due to high budget deficits and excessive inflation expectations could further stoke commodity prices. For this reason, we expect the diversification and inflation-protection properties of commodity stocks to remain attractive to financial investors in the future and provide a boost to the sector.

In the commodities sector, we are focusing on individual stocks of large companies such as BHP, Equinor and Royal Dutch, as well as Lafarge Holcim, and mixing in smaller companies using an actively managed fund. Indirectly, we are also active in this segment via the Russian equity market, which is dominated by commodity stocks.



**Dr. Matthias Ramser**
CIO

# New situation demands rethinking

Why Yale now invests its own endowment funds very differently.

**Interest rates have only gone in one direction in recent decades: downwards. Would a balanced portfolio that has proven itself in this environment also stand out against the competition?**

Renowned Yale University, north of New York, was founded in 1701. It has a long tradition of excellence and a student population of around 11,000. The management of the foundation's assets of approximately USD 30 billion pursues the goal of "balancing the competing objectives of (1) supporting today's scholars with annual spending distributions and (2) maintaining that support for generations to come." As a result, its investments are dynamically aligned with the current environment and emerging opportunities. For example, in 1989 Yale held around 65% in stocks and bonds of US companies. Today, this proportion is less than 10%! Instead, according to Yale, over 90% are now in "diversifying investments such as foreign equity, absolute return strategies, real estate, investments in start-up companies and natural resources".

**Return expectations set the framework**

When one considers that in 1989 US government bonds yielded around 10% and US equities offered the tempting prospect of an expected return of around 7%, according to the Shiller P/E, this is hardly surprising. Today, US government bonds offer just under 2% p.a. After adjusting for inflation, the yield is actually negative. Furthermore, the expected return on shares is also lower than it was back then. Many investors are currently facing a "trilemma": out of three possible strategies, only a maximum of two can be selected at the same time.

- Prefer traditional investments with high liquidity and low complexity
- Seek stability in the form of limited fluctuations in value (especially in correction phases)
- Preserve assets in the face of inflation and target an attractive yield

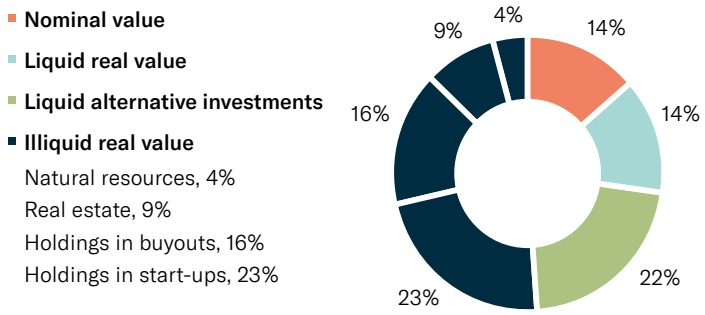
If you choose the first two, a high proportion will be in liquidity and bonds. The risks of a real value loss are correspondingly high. If you opt for the first and the third strategies, the core allocation will be in equities, with the portfolio correspondingly exposed to market fluctuations. If the last two are chosen, the portfolio will have a strong focus on real assets and non-traditional investments: equities, real estate, precious metals and alternative investments.

Yale has chosen the latter route and mixes in a substantial amount of alternative investments. Based on the latest report, these are favoured because of their two main advantages: 1) potential returns and 2) diversification effects. According to Yale, alternative assets tend to be less efficiently priced than traditional marketable assets, which offers an attractive opportunity to exploit market inefficiencies through active management.

**Yale with a generation-spanning outlook**

With falling return expectations on equities and indeed a negative return on bonds, a broader outlook is indispensable for a balanced portfolio. Consequently, Yale sets the proportion of illiquid investments in its portfolio at 50%. However, whereas Yale University's time horizon is quasi infinite, that is not the case for "the likes of us". For many, a ratio of 50% of illiquid investments is probably rather high – even if the integral view including residential property, pension fund assets, etc. should always be maintained.

YALE: THINKING ABOUT GENERATIONS




Source: The Yale Endowment Report, own representation

Whether illiquid investments are suitable as a diversifying and yield-enhancing component in the range of 25%, or whether, like Yale, one decides to go as far as 50% with a view to future generations, is a choice that must be individually determined to your specific starting position and integrally adjusted to match the values. Our relationship managers are available at any time to assist you.



**Patrick Seifert**
Clients

# Real value with attractive cashflows


Interview with Dr. Stefan Hasenböhler

**Why and since when have you been investing in infrastructure?**
With InRoll AG, we founded our first investment solution for the freight-car sector in 2012. At the time, however, we were not thinking in terms of "infrastructure investment". The investment in a real asset, freight cars, and the achievement of stable returns by means of long-term rental agreements are what appealed to us. Over time, we became aware that these were benchmarks for infrastructure assets, and we expanded our scope to include transport, energy and waste disposal – with a steady focus on Switzerland and Europe.

**How does that translate into numbers?**
When founding InRoll, we started with an investment volume of CHF 15 million, and today we oversee around CHF 450 million. Altogether, we currently manage over CHF 1 billion in various infrastructure funds and mandates. Initially, our expertise was concentrated in just a few individuals, but today, we have a diversified team with a wealth of experience in all three of the areas mentioned.

**What have been the highlights for you personally so far?**
I would definitely say the long-term and successful partnerships that we have been able to form thanks to our investments. For example, with Wascosa in the case of InRoll AG, with Peter Spuhler and his team at our locomotive hiring company "European Loc Pool", and as well with Rolls Royce & Partners Finance for aircraft engines. It is also exciting whenever we make onsite visits to our investment locations, which is part of our due diligence process.

**What have been the biggest challenges up until now?**
It's not that infrastructure investments do not involve risks – they just have different sources of risk compared with conventional financial market investments. We've already had delays in the delivery of locomotives, and a freight-car manufacturer had to cease operations, so we were obliged to cancel orders as a result. Also, a waste disposal company in Switzerland experienced capacity issues during the first lockdown.

**What were the consequences?**
In such situations, the fact that you have carefully created a stable legal basis in advance always makes a tremendous difference. Working with counterparties with whom you can hammer out solutions to problems is also key. So far, we have always succeeded in finding a solution.

**The topic of ESG and/or sustainability is central to infrastructure investments – same for you?**
Yes it is, and it is an essential issue for many investors in our infrastructure solutions. In the transport sector, we are seeing a strong trend towards investment in rail as it is responsible for only 1% of $CO_2$ emissions in the overall transport sector, while 70% are caused by road traffic. In the energy sector, we focus on renewable energy.

**Such as?**
We acquired the Morteratsch hydroelectric power plant in the canton of Graubünden, for example, and renovated it. We are feeding the "green" electricity to the Swiss power grid for a period of 20 years. The situation is similar with a wind farm in Sweden. The 11 wind turbines are now owned by our infrastructure fund, and the electricity they generate is delivered to a large Swiss energy supplier under a 10-year contract.

**Who is best suited to invest in infrastructure assets, and how can this be implemented?**
An infrastructure investor should have a long time horizon as infrastructure investments are themselves also long-term. Our defensive risk-reward approach is not suitable for investors who want to "get rich quick" with their investments, but rather for investors who appreciate ownership of real value assets and are looking for stable returns. Your relationship manager will be happy to talk to you about which infrastructure instruments are available and outline their advantages and disadvantages.

**More on this topic in German:**