CHECK-UP

May 2022
Client information
Reichmuth & Co Private Bankers

Growth risks – high demand meets scarce supply.
P. 4

Investing during stagflation – alternative investments with tailwinds.
P. 6

Proven e-banking, now with even more benefits.
P. 7

Editorial

Shock waves are reverberating around the world. Russia's invasion of Ukraine is an incomprehensible and reprehensible tragedy. Energy and commodity prices are rising as a direct result, which in turn is fuelling inflation. The expected crop failure in the breadbasket of Europe and the resulting higher food prices are likely to affect us all. The sanctions imposed by the West will also have serious long-term effects for investors, who must prepare for stagflation in the near future. That is what we will focus on in this Check-Up.

We will introduce you to our mobile app on page 7, which gives you an up-to-date overview at all times (24/7) of the assets you have entrusted to us. Plus, with secure digital access, you can help to reduce paper consumption. We will happily explain the benefits to you in more detail and let you try it out for yourself.



Jürg Staub
General Partner

Regime change



The globalised world economy is crumbling

The Ukraine conflict is not a proxy war: Russia, a nuclear power, is attacking its neighbour with military force. As a result, the options for the international community to respond are limited. The West has reacted with tough sanctions – and is willing to accept the consequences even during an already extremely difficult period. This is especially true for Europe. We are now being presented with the bill for the policies of the last decades. The peace dividend has been spent. We depend on the US for security. We have relied on export markets in Asia, especially China, for growth. And we placed our trust in Russia for our energy supply, a country that was supposed to provide the indispensable raw materials for the energy transition at the same time. This war may be uniting the West, but its sanctions are dividing the world.

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Sanctions as weapons
Russia's isolation, and the freezing of its central bank reserves in particular, will have a permanent effect on the current world order. Russia's commodities have not disappeared, but are being sent elsewhere. The global USD-based world trading system will split into blocs. The USA had already rolled out the Iran sanctions to the world via the USD. The message at the time was "Either you support them or you lose access to the USD market". The freezing of central bank reserves will make other countries in the world wonder whether the same thing could happen to them. Consequently, they will want to prepare themselves for the future.

Europe at an impasse
Europe is facing an enormous dilemma. How can we stop our reliance on Russian energy? Who will supply the raw materials that Europe needs as it transitions to renewable energy in the fight against climate change? We must expect persistently high energy and commodity prices, which will put a strain on the economy and on households. Governments will attempt to alleviate this burden through even more state intervention such as price controls or subsidies, while at the same time upgrading their atrophied security structures with big budgets. Who is going to pay for all this?

From fighting deflation to inflation
There are no longer any painless options. Either taxes will rise sharply or this expenditure will be financed – as per usual over the past 15 years – with new debt. The only difference is that new debt can no longer be monetised via the central bank through bond purchases. The central banks always justified their excessive printing of money and negative interest rates as part of the fight against deflation. That argument is now invalid. The ECB is also woefully behind in the battle against high inflation. There is a risk that it could even spiral out of control if QE is extended. So, investors will have to absorb the new debt – but in view of the high inflation, at what interest rate will they be prepared to do so? Interest rates would inexorably rise, which would plunge the highly indebted European countries into difficulties, producing a type of EUR Crisis 2.0 – a vicious circle that no one wants!

Who would profit?
The beneficiaries would most likely be China and countries from the non-Western bloc. The liberal, rules-based economic order is being stifled by more and more state intervention. A new peril is also manifesting itself for investors: the risk of sanctions.

Higher inflation – lower growth
Even before the Ukraine war we were already forecasting higher inflation. Now, we expect this to last longer and be accompanied by lower growth. Analyses of past periods of high inflation or even the stagflation years of the 1970s can help here. We analysed these phases and identified the main lessons learned in our book "Déjà-Vu" (available in German at www.reichmuthco.ch/privatkunden/publikationen). Throughout the entire period, investors holding shares, precious metals and real estate weathered the stagflation best. However, there are also differences between then and now, e.g. in what currencies were doing at the time and the credit restrictions. It is also important to examine the progression, or sequences, in order to react in the best possible manner to the pronounced ups and downs. Nominal investments held very little value over the entire period. They may be less volatile, but when interest rates rise, their price also falls temporarily, and with inflation they quickly lose real value over the entire term.

Equities, precious metals and alternative investments
For this reason, we still prefer equities despite increased volatility risks, but we vary the allocation more around the strategic mean value in an attempt to take advantage of the ups and downs of the markets. Precious metals do not yield any income, but can be valuable in real terms and offer support in crises. Alternative and infrastructure investments diversify your portfolio and generate partially inflation-protected returns. To ensure a steady income and take advantage of opportunities, you need an individually tailored tranche of nominal investments and especially short maturities.

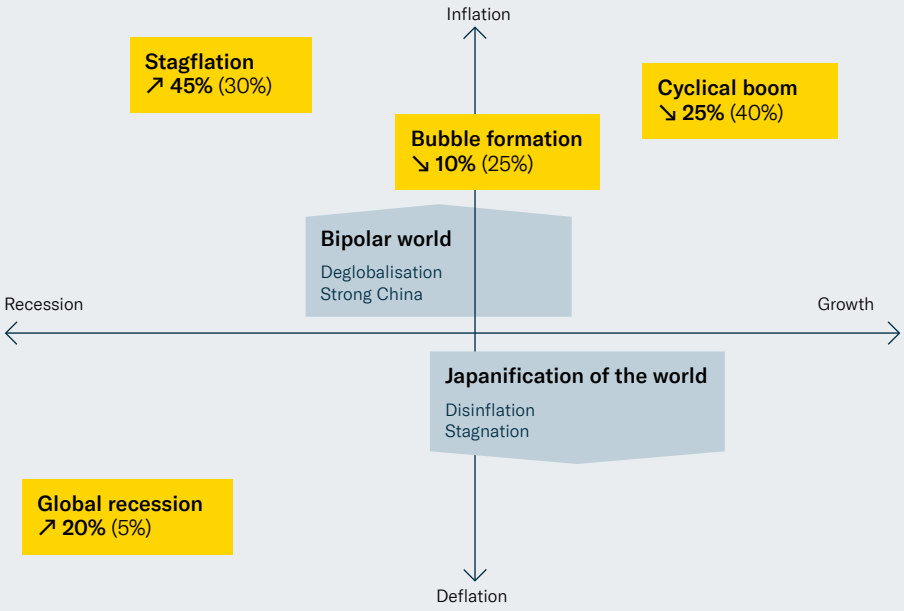
Does this crisis also offer opportunities?
The chances that the events of the previous weeks will turn out just to be a nightmare, that we will wake up and find the world as it was before, are unfortunately very slim. For those of us in the sanctioning West, this means there are few opportunities at present, but they will come. There are too many moving parts with hard-to-predict consequences. But it is also important to pursue scenarios that are positive for financial markets in the West. A ceasefire in Ukraine and peaceful coexistence are obvious crucial elements and a prerequisite for the exit from harsh sanctions, which is central for Western financial markets.



Christof Reichmuth
General Partner

Our scenarios

New era leads to decoupling



Current assessment

- Tectonic shifts due to geopolitical disputes
- Deglobalisation receives strong support
- Focus on inflation and how to fight it
- Europe cripples itself; US gets off lightly and China is the big winner

Scenarios Underlying trends Estimated probability of occurrence, amount from last publication shown in brackets in each case

In Focus: Stagflation

Stagnating economy with rising prices

If harsh sanctions are imposed on a country with a very positive trade balance, global repercussions occur. In the case of Russia, this means much higher commodity prices, creating the potential for social unrest in various places around the world. Soaring inflation rates are having an increasingly negative impact on economic growth. The European economy will suffer the most from trade barriers due to its high energy dependence on Russia. With Europe turning away from the splintering Eurasian bloc, the ECB will have to work hard to avoid falling too far behind in terms of timing with the inevitable rate hikes to come.

Investment ideas

- Underweight equities
- Focused sector weighting (energy and healthcare)
- Utilise and diversify alternative return premiums
- Head for safe currency havens
- Use gold as a crisis hedge

OUT-OF-THE-BOX

Scenario: Globalisation 2.0

The sanctions adopted by the West against Russia prompt Putin to accept a diplomatic solution in which he can announce face-saving victories and end military action in Ukraine. Global inflationary pressures diminish as a result, with inflation rates settling at levels close to central bank targets. Therefore, central banks do not have to aggressively raise their key interest rates and companies can maintain their (in some cases) high margins relatively easily. The pent-up demand from the pandemic leads to a cyclical boom once again. Even the trade war with China and the interdependencies that it lays bare cannot curb globalisation.

Investment ideas

- Overweight equities (give preference to cyclicals)
- Pandemic losers (travel sector)
- Small & mid caps

Cajetan Bilgischer and Silvan Betschart

Growth risks

High demand meets scarce supply

High inflation and declining growth are bringing back memories of the stagflation phase of the 1970s and early 1980s. Much like back then, an unexpected supply shock – caused this time by disrupted supply chains and war-related sanctions against the world's largest commodities producer – is leading to sharp price increases. Geopolitics with an increasing trend to the formation of blocs is preventing a rapid recovery on the supply side, and inflationary pressure on prices threatens to become structural. Although there are some differences from the 1970s, many factors indicate that we are in a stagflationary phase. What are the most important lessons learned from the past? From a portfolio perspective, history favours holding a small amount of bonds, an active and focused sector allocation in equities, and more alternative investments.

End of the USD as the world's reserve currency?
In contrast to today's situation, the beginning of the 1970s saw a shake-up of the international monetary structure. The exchange rate regime established at the end of World War II (Bretton Woods) collapsed, and the USD, the reserve currency, depreciated drastically. Currency devaluation was one of the triggers for the inflationary phase. In the current context, the USD has been stable and actually gained strength. Nonetheless, in the wake of the seizure of Russia's foreign exchange reserves, the incentive for "non-Western" countries to hold all their foreign exchange reserves in USD is likely to be reconsidered. This applies not only to the USD, but also to the EUR as a close ally of the USA. In any case, foreign currencies remain unattractive for CHF investors at present. As long as the inflation rates in the other currency areas remain significantly higher, this will favour the CHF and weigh on foreign currencies. When inflation expectations lost their anchor and surged higher in the 1970s, the price of gold rose sharply and was one of the few investments that did not lose real value in that decade. Gold remains an appealing insurance policy in case central banks fail to keep inflation expectations anchored.

Growth slowdown
The US yield curve has flattened and was even inverse for a short time. Historically, this has been a reliable warning signal for a recession or a reversal on stock markets. The lead time of this indicator was on average about 12 to 18 months. However, as many signs are pointing to structurally higher inflation, we remain cautious on fixed-income investments and consider it premature to increase duration risks. The supply of bonds is continuing to grow with new debt, while the demand for bonds is falling in an inflationary environment. This suggests that long-dated yields will continue to rise despite growth fears.

Headwinds for equity markets
In an inflationary environment, companies' nominal revenues rise with increasing prices, which means that equities offer certain protection against inflation in the long term. However, we see two risks for equity markets in the short term: 1. The inverted yield curve indicates that an economic slowdown and negative earnings revisions are expected. 2. But should the yield curve steepen again in the coming months due to rising inflation expectations, share valuations could come under further pressure. The combination of negative earnings revisions and valuation pressure is not a good environment for an overweighted equity allocation. Instead, we recommend holding some cash and a higher proportion of alternative investments.

History favours holding a small amount of bonds, a flexible equity allocation and more alternative investments.

New commodities cycle
Tax breaks, subsidies and price caps were introduced in the 1970s to protect consumers from rising commodities prices. This provided relief for consumers, but the excess demand persisted even longer, and bottlenecks on the supply side were not resolved. The final outcome in the 1970s was that the central bank eventually had to raise interest rates much more sharply to eliminate this excess demand in the real economy. In today's world with the political will for clean energy and now energy independence as well, the demand for specific raw materials will remain high. As a result, price trends for commodities and interest rates may continue for some time and even overshoot. Therefore, we do not expect a quick departure from interest rate hikes in the current environment. A stock market correction could though at least slow down the pace of the hikes.

Healthcare and energy stocks heavily weighted
Good, stable margins are important when selecting stocks. In addition to commodity prices, higher financing and labour costs will also weigh on margins in the second half of the year. Within the individual sectors, healthcare stocks are displaying limited exposure to increasing input costs. The effects of rising financing costs should also remain manageable thanks to mostly solid balance sheets. Negatively exposed sectors include consumption, in particular, as inflation erodes consumers' purchasing power over time, and spending on non-essentials declines. It is especially important to focus on sector allocation in an inflationary environment. The winners of the previous deflationary decade are now highly weighted in the indices; however, they are not our first choice in the current inflationary environment.

Taking advantage of price fluctuations
Quality companies with big, stable margins will remain in demand. Of course, when interest rates rise, valuations in this segment may also come under pressure. However, we view price declines in quality stocks as a buying opportunity, especially if it becomes apparent that the current surge in inflation is weakening. We expect continued high volatility in the markets over the next few weeks. There are entry opportunities with some quality companies, but also in growth segments that have been hit particularly hard (e.g. biotech). On the other hand, it is also important to at least take some profits in the event of significant price increases (e.g. for energy companies).

Diversification
Alternative strategies that are less correlated with the fixed-income and equity markets not only offer attractive returns opportunities for the coming months, but are also key contributors to portfolio diversification. In the 1970s, apart from gold there were hardly any alternatives to equities and bonds. Today, there are various alternative investment strategies to choose from that can diversify a traditional portfolio – especially during periods of stress and prolonged bear markets. We recommend using alternative investments to reduce part of the interest rate and equity risks. The best ideas on this topic can be found on page 6.



Patrick Erne
Head of Research

Energy transition as an investment opportunity

The current energy crisis will serve to further accelerate the political will to invest in renewable energies. The need for energy security is accelerating the investment boom in green technologies, making revenue and profit prospects particularly attractive for companies in this sector. We see opportunities in the following areas:

Energy efficiency: Energy control and the efficient cooling and heating of buildings are increasingly important factors. Companies such as Siemens, Schneider Electric, Belimo and Zehnder hold strong market positions.

Select commodities: Copper, nickel, lithium and aluminium play a key role in battery technology. Demand for selected metals is expected to increase further (e.g. GNO Resources, UCITS funds, BHP).

Sustainable energies: In addition to solar and wind energy, there will also be greater demand for hydropower, biofuels and even nuclear technology. Companies in this sector are likely to experience high growth (e.g. Orsted, RWE, Clean Energy ETF and active thematic funds).

There are a number of options here, such as individual stocks, thematic ETFs and active funds managed by specialists. Interested in this topic? We would be happy to advise you in a personal meeting.

Investing during stagflation

Alternative investments with tailwinds

Mixed mandates in equities and bonds are rewarded with attractive yields over the long term – but history shows that this varies greatly depending on the market environment. Thanks to declining interest rates and very good equity markets, these traditional portfolios have enjoyed a bonanza since the financial crisis.

With the current stagflation risks, we are facing a regime change with new, clear trends. This is presenting challenges for traditional investors:

- Interest rates have entered a multi-year, structural upward trend. Coupon payments on bonds are now barely sufficient to compensate for the interest rate risks. “Safe bonds” will not generate attractive performance contributions, especially after adjusting for inflation.
- Equities are at historically high values in some cases, and headwinds are increasing. On the one hand, rising interest rates are putting pressure on valuations, especially for growth companies. On the other, margins are expected to be squeezed due to rising wage and input costs.

In the long term, quality stocks that can pass on cost pressures over time remain attractive – but volatility is likely to increase. What opportunities are available to generate a real return in this challenging environment? Traditional investments can only deliver to a limited extent and require active portfolio management. Alternative investments, on the other hand, offer promising opportunities at various levels in our opinion:



Focusing on new market trends

These strategies pick up on price trends on the market and profit when they move in one direction for longer periods. Negative inflation surprises can often be capitalised on profitably, along with price trends on the commodities markets or in commodities currencies that could also last longer. Moreover, these strategies also incorporate the current negative price trend in bonds.



Flexible trading strategies

Uncertainties and regime changes provoke higher volatility on markets with short-term overshooting or undershooting of prices. For active trading strategies that can also invest during bearish periods, these market movements offer attractive opportunities, especially in a sideways market.



Price divergences between individual stocks or sectors

The environment for fundamental equity investors is also improving. Regional dependencies, regulations, production footprints, cost structures and other factors are regaining their importance. Active selection can pay off and beat investments focused only on an index, which have a high weighting among past winners.



Unlisted investments with low volatility

Volatility on stock markets makes many investors nervous. Investments in unlisted real assets that generate recurring cash flows will remain in demand over the long term. The addition of these investments will stabilise your portfolio, generate income and offer solid protection against inflation. The focus here is on infrastructure and agricultural investments.



Recovery/restructuring for non-performing loans

Against a backdrop of sharply rising global energy and food prices, sanctions and negative growth stimuli in a highly indebted system, we expect to see new opportunities in the area of non-performing loans in the coming months.

We have been investing in alternative assets for more than 25 years, and our experience shows that these offer attractive features, especially during market phases that pose challenges for traditional investments. We have recently increased the weighting of alternative investments in our corporate strategy and would be happy to show you which alternative investments are best suited to your individual portfolio.



Silvan Betschart
Research, Head of
Investment Policy

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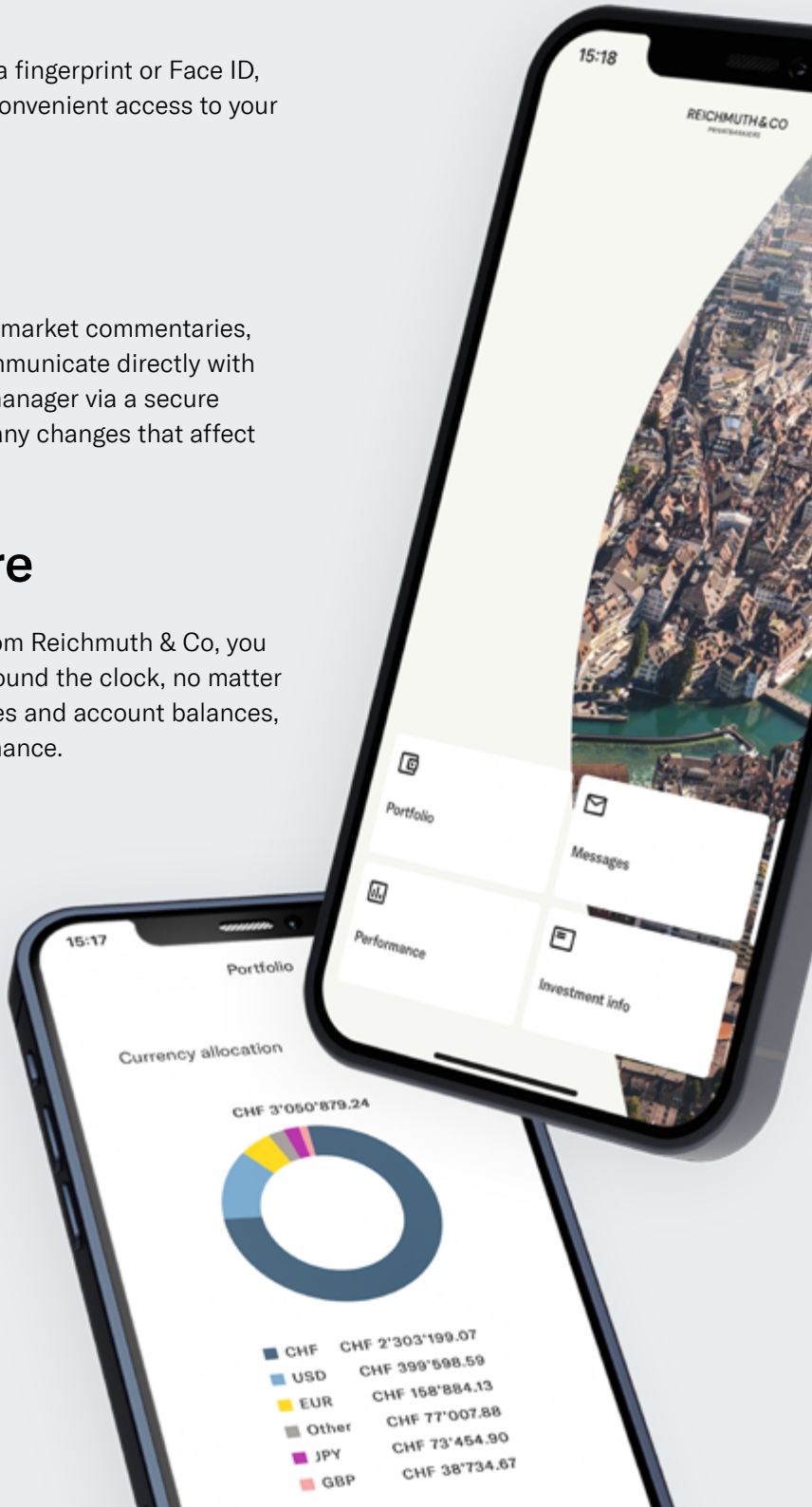
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You can use the mobile app with your existing access data for personal e-banking. Our client relationship managers are also happy to hear from you with any questions or suggestions you may have.

Click here.

Long-term and integral thinking



An interview with Remy Reichmuth, CEO

Your take on 2022 so far?
Over the first few weeks of the year, we were able to hold many of our yearly discussions with thoroughly satisfied clients – which was also a pleasure for us. As stated in the January Check-Up, we expected a volatile 2022 with emerging inflation. This manifested itself rapidly in weaker stock markets, and the situation became turbulent with the escalation in Ukraine.

How did the latter development affect Reichmuth & Co directly?
The suffering of the population naturally affects you personally – it wrenches your heart. In terms of our business, we are focused on Switzerland, while abroad we primarily serve clients from Germany and Austria. Russia was never a target market for us. As a result, we have no clients from the region and are not affected by the sanctions imposed on Russian citizens. In terms of investments, broad diversification has proven its worth. However, the war is obviously causing secondary effects and repercussions for the whole world. The geopolitical situation remains dangerous, including for financial markets.

How are your clients reacting to the turbulence?
No one likes a negative portfolio performance and great uncertainty. Nonetheless, many clients anticipated that the book losses incurred in the first quarter would be higher than they actually were. With some clients, we decided to increase diversification into alternative risk premiums such as gold, infrastructure or trend-following strategies. Some have reduced equity risks, while others used the lower prices to invest their available liquidity. Of course, it always depends on how much exposure an investor already has and how willing or able they are to accept volatility.

Your outlook for the coming months?
The environment remains challenging, especially when many stocks cannot simply benefit from low or even negative interest rates and are trending upwards. As a father of three children, I find myself, like many others, very concerned about global developments and their long-term consequences. Often, the escalation of events is what actually makes a solution possible. Even in such times, it is essential to focus on opportunities in order to secure or increase assets in the long term.

What is your advice for our readers?
Firstly: Think long-term because the time horizon is fundamental for investment success. We see it time and again – the returns you miss out on if you do not hold shares are many times greater in the long term than the temporary book losses you have to accept if you invest. Or to put it in actual numbers: If over the last 50 years you calculate any start of the year as an entry point and any annual holding period – i.e. one year, two years, three years, etc. – with the global stock index, then you would have achieved a negative investment result in only 51 of 1'275 possible cases. And with a minimum holding period of five years, it would only be six out of 1'081 cases! That's why you must not succumb to short-term thinking in phases like the current one.

And secondly?
Integral planning! Investors have to live with market volatility, you simply cannot influence all of the factors. But when it comes to your personal financial and succession planning, the situation is different. This is where profits can be secured, for example through tax advantages. At the beginning of a new regime, as is currently the case, this integral view of risks and opportunities is central to your overall positioning. We would be happy to discuss the specific options available for you and your family.

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