Check-Up

Client Newsletter of Privatbankiers Reichmuth & Co
Integral Investment Management | May 2015

Editorial
The 2015 investment year has got off to an exciting start, and once again it has been the central banks that have set the tone. The SNB's decision to abandon the minimum exchange rate to the EUR in mid-January was a capitulation in the face of the ECB's money printing program. Depositing cash with a bank free of charge is rapidly becoming a privilege rather than the norm. And so the signs are pointing to bubbles forming on the financial markets.

The appreciation of the CHF is hitting the economy hard. That said, it should at least curb the zeal for regulation in Switzerland. Prosperity cannot be dictated by the state, it must be earned afresh every day. Liberal forces and those critical of the state are likely to finally enjoy a slight boost. The next test is already in the offing with the referendum on the inheritance tax initiative on June 14, 2015. We are counting on your 'NO' vote! ■

Jürg Staub, General Partner

BUBBLES FORMING

ECB purchase program and negative interest rates

Is the Swiss equity market index SMI more likely to double or be slashed in half?

The index is currently trading at a price/earnings ratio of 20 and a dividend yield of 3 %. If this were to be halved, the P/E would fall to 10 and the dividend yield would rise to 6 % – truly attractive levels. A doubling, on the other hand, would see the P/E reach 40 while sending the dividend yield to 1.5 % – this would be very expensive, and would in fact constitute a bubble. While an increase of this magnitude is not on the cards, the formation of bubbles is in full flow against the backdrop of negative interest rates and the ECB's massive purchase program.

Can the ECB solve the problems?

The ECB appears to be the only player in the Eurozone capable of action, and it is indeed doing its utmost to stimulate the economy. However, it cannot resolve the real problems. For years now, it has been buying time, which the politicians have frittered away. For its latest program, in which it plans to buy securities worth EUR 1,140 billion, it is delving deep into its box of tricks. Will this improve the competitive position of southern Europe? No, since in the absence of national currencies the rigid EUR concept makes wage cuts necessary, something that is difficult to impose. What can the ECB achieve then? As said before, it can buy time and weaken the EUR, and it has succeeded in doing so. This will persist at least for as long as the markets believe in its measures. We expect this to be the case through to the end of 2015. Toward the end of the year, the market will then ask itself what will happen after the ECB's program expires in September 2016. Until such time, the flood of money is likely to cover over even the Greek problem.

"The winner takes it all…"

… and the winner is Germany. It is becoming increasingly apparent that the lack of exchange rate flexibility between the Eurozone countries is cementing Germany's position of strength. Coupled with the weakened EUR, this is helping deliver higher profits, which is in turn

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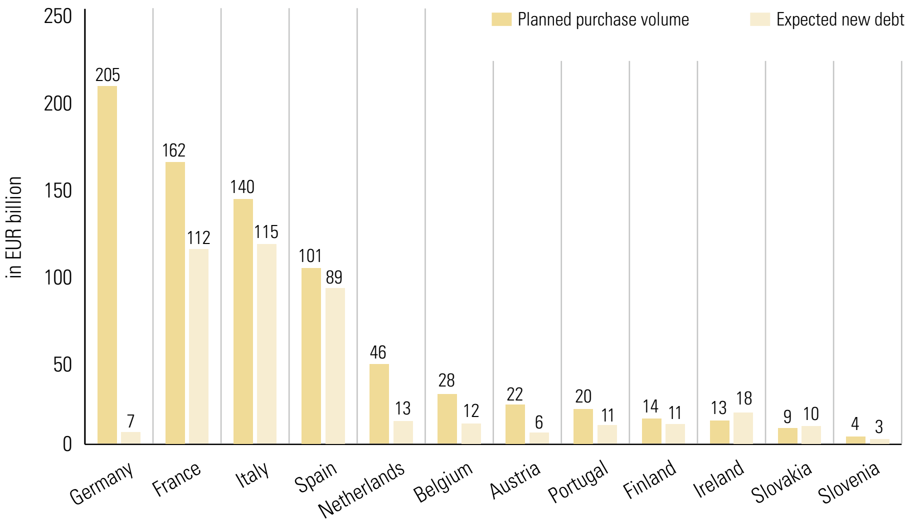
ECB buying program – who will sell EUR 200 billion worth of bunds?



Sources: Bloomberg, own data

likely to lead to higher wages. If Germany's success does lead to somewhat higher inflation, this would bring at least modest relief for southern Europe. That said, we clearly expect to see the strongest tailwinds to the north of the continent, and in Germany in particular.

Bundesbank buying government bonds

In this environment, Germany's Bundesbank – an avowed opponent of the ECB program – ironically has to buy more than EUR 10 billion worth of government bonds every month, given that the ECB is implementing its moves via the national central banks. Germany does not need this glut of liquidity, and does not want sovereign debt to increase. This means the Bundesbank will have to buy the bonds on the market. Who will sell? The Swiss National Bank (SNB)? And what are the sellers then going to do with the proceeds? In Germany, too, interest rates are at zero up to maturities of ten years.

Will the SNB sell?

The SNB has other issues to contend with. It wants to weaken the CHF. The minimum exchange rate had to be lifted, and now the bank is sitting on large holdings of European government bonds. This would be a good time to sell these back to the Europeans. The only thing is, the SNB would then have euros and would have the option of exchanging these into other currencies – not the CHF – or into other EUR-denominated securities, such as equities. It is unlikely in the foreseeable future that the SNB will peg the CHF to a currency basket and found a sovereign wealth fund to manage currency reserves. This would require preparatory work on the political front. Although we regard the current regime of negative interest rates as far from good, we expect it to persist.

Slim pickings for investors

For investors looking to the future, the cupboard is becoming increasingly bare. High cash holdings are already being hit by negative interest rates in many places, and first-class bonds in CHF – and also in EUR – are no longer delivering any returns. Meanwhile, although equities are offering comparatively attractive dividends, the protracted rally means the threat of a correction is not inconsiderable. Illiquid investments are not in favor: they may be relatively attractive, but the lack of liquidity is not being handsomely rewarded.

Join the bubble?

Bubbles are therefore in the offing, particularly in Europe and above all in Switzerland. To date we have consistently advised against participating in the formation of such bubbles. This time, however, the alternatives are extremely thin on the ground. Added to this, the disastrous negative interest rates have not yet properly eaten their way through to investors. Coupled with the respite bought by the ECB and the glut of money, the formation of bubbles is therefore likely to persist. We know this is a strategy entailing higher risks, and that there are numerous scenarios that could trigger market corrections. However, we believe there is little probability of any of these occurring at present.

Consider a put program

We therefore continue to recommend that dividend stocks form the backbone of a portfolio. The higher the stock markets climb, the more a partial hedge with put options should be considered. This could, for example, entail using around a fifth of the earnings from every 10 % gain in share prices to buy put options. This would cushion the blow of a correction. Investors able to take larger fluctuations in their stride could certainly refrain from such a program. For all others, it should be started and phased in in the course of this year. We look forward to discussing this with you. ■

Christof Reichmuth, General Partner

OUR SCENARIO ANALYSIS IN A NUTSHELL

Our take on the future

Bubbles forming – financial repression and stagflation
Global growth remains below potential. Modest interest rate hikes are on the cards in the US only, while the central banks in other regions continue their expansionary courses, keeping interest rates low or even negative. Amid the dearth of alternatives, investors are forced into anything offering returns. An asset value bubble forms. Politicians refrain from making key structural reforms. The real economy remains weak and unemployment high in many industrialized countries. Despite official inflation being low, the loss of purchasing power for savers is high. Social tension mounts, tempting politicians into even more redistribution. Trust in central banks and state authorities reaches tipping point.

Investment ideas
- Dividend stocks
- Stocks of global leaders
- Real estate
- Infrastructure investments with inflation protection
- Gold
- USD

70%
probability
12 months

Growth – central banks are too late
Low interest rates and the low price of oil stimulate growth worldwide. Lower unemployment leads to higher wages and inflation in the US. The Fed has to raise interest rates more quickly and more strongly than expected. The USD becomes even stronger. The equity markets correct sharply for a time, in particular in the US (where margins come under pressure) and the emerging markets (where many companies hold debt in USD). Growth gathers pace in Europe. Thanks to the rising inflation differential between Germany and the crisis-hit countries, the imbalances are canceled out. Confidence returns, capital spending increases, and a sustained reduction in debt is achieved with some inflation and growth.

Investment ideas
- Stocks from cyclical sectors, with a focus on northern Europe
- Emerging markets
- Temporary hedging in the US
- Commodities
- Hedge funds
- USD

15%
probability
12 months

Regression – deflation and recession
Growth declines in the industrialized countries. Budget deficits rise, as do debt levels. The strong USD heightens the pressure on companies and countries with debt denominated in USD. The monetary policies of the central banks increasingly fall into the deflation trap. Scarcely any investment is made and consumers suffer under the debt burden. Asset values correct sharply, piling on the deflationary pressure. Despite the zero interest rate policies, falling prices mean real interest rates are positive. The savings rate rises, whereas capital spending declines. The tensions in the Eurozone mount, and there are either equalization payments or debt restructuring, as well as currency exits.

Investment ideas
- First-class bonds
- Flexibly hedge funds with short strategies (e.g. short credit)
- Gold as a store of value

14%
probability
12 months

Real solutions – the right thing for the future
Genuine structural reforms are implemented. These include:
- Dissolving excessively rigid currency regimes such as the EUR and introducing parallel currencies
- One-off capital levy to finance a bad bank for the excessively high sovereign debt burden
- Haircuts for overindebted countries
- Nationalization of banks and insurers that are made insolvent as a result
- Pension reform: raising the retirement age and cutting pension promises

Following a turbulent phase with a pronounced slump in asset values, the foundations are set for new beginnings.

Investment ideas
- Stocks of global leaders, these should be hedged with exchange-traded put options (low counterparty risk)
- Physical gold in Switzerland

1%
probability
12 months

MARKET OUTLOOK

2nd Trimester 2015

Max Rössler

> *The CHF is extremely overvalued, interest rates unprecedentedly low, and the equity markets have been rising for six years. The normalization of the financial markets is a long time coming.*

Currencies

The most important event for CHF investors in the year to date has been the Swiss National Bank's decision on January 15, 2015 to abandon its support of the EUR at CHF 1.20 and the strong appreciation of the CHF that ensued. This decision caught virtually all market observers by surprise, at least with regard to the timing. The upsurge in the CHF has since stabilized at an average of around 10 % vs the major currencies, and will probably remain at this level in the coming months. The USD will continue to tend firmer for the time being, above all vs the EUR.

The more favorable economic development in the US compared to Europe and Japan, coupled with the expected widening in the interest rate differential between the USD and the other main currencies, is continuing to favor the USD. However, the marked appreciation of the USD that has taken hold in recent months and the collapse of the oil price are having an increasingly negative impact on the US economy, while the German export industry, for example, is on the other hand profiting from the low EUR. This is leading to a rising current account surplus for the Eurozone. Over the longer term, this could result in a turnaround in the exchange rate trend and tend to weaken the USD. As regards the other currencies, the decline in the currencies of commodity countries was the most striking development, these suffered due to the slump in commodity prices, especially that of oil. Given that commodity prices are now likely to have bottomed out on average, some of these currencies – such as the CAD or NOK – have potential to stage a recovery in the coming months.

Currency	**Exchange rate**	**Expectation**
	17.04.2015	12 months
USD	0.95	↗
EUR	1.03	↗
GBP	1.42	↗
NOK	12.15	↗
CNY	0.15	↗
JPY	0.80	↗

Interest rates

The central banks remain expansionary because inflation rates are still declining, chiefly due to the sharp drop in the price of oil. In some cases (e.g. Switzerland) inflation has edged into negative territory and thus lower than the 1 % to 2 % targeted by the central banks with a view to monetary stability. Interest rates therefore essentially remain at levels that are extremely low by historical comparison.

As regards the individual currencies, the interest rate trends on the cards over the short term are something of a mixed bag. In the US, in light of the rising economic growth, the Federal Reserve ended its QE program as planned and announced an initial rise in key interest rates soon. However, this has been repeatedly postponed and made subject to certain conditions being met. It remains uncertain at present whether this interest rate hike will come this year, or whether it will be delayed until 2016. In Europe, the European Central Bank has just started buying long-term government bonds, and EUR interest rates will remain close to zero for some time yet. The interest rate outlook in Japan is similar. In Switzerland, following its decision to abandon the minimum exchange rate to the EUR, the SNB is endeavoring to check the appreciation of the CHF by ensuring a sufficient interest rate differential vs the EUR. CHF interest rates are therefore set to remain negative for a lengthier period, and in any case longer than initially expected.

Country	3M Libor	10y swap	Inflation
	17.04.2015	17.04.2015	
Switzerland	−0.8 % ↘	0.0 % →	−0.9 % ↗
US	0.3 % ↗	1.9 % ↗	−0.1 % ↗
Germany	−0.0 % ↘	0.4 % ↘	0.3 % ↗
Italy	−0.0 % ↘	0.4 % ↘	−0.1 % →
UK	0.6 % ↘	1.7 % →	0.0 % →
China	4.6 % ↘	4.0 % ↘	1.4 % →
Japan	0.1 % →	0.5 % →	2.2 % ↘

Stock markets

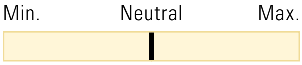
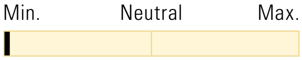
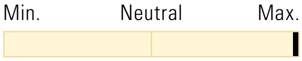
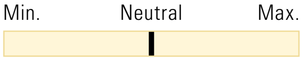
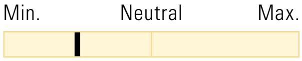
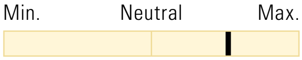
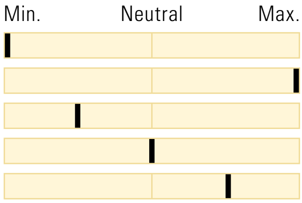
Since the beginning of the year, the general trend on the equity markets has been fairly steadily pointing upward. Fundamental valuations have therefore continued to rise on average. There is a lack of other attractive investments, above all by comparison with the low yields on bonds and with cash generating absolutely nothing or even hit with negative interest rates. Owing to this dearth of alternatives, the uptrend will probably remain intact, even if the threat of sudden share price slumps has increased.

The most important argument in favor of buying equities remains the good dividend yields offered by many first-class companies whose earnings are relatively independent of economic fluctuations and are therefore likely to deliver regular dividend increases rather than cuts. For investors who are more willing to take on risk, another suitable option would be to invest in those countries and sectors that have lagged well behind of late, contrary to the general uptrend. These include certain emerging markets that are heavily dependent on commodity exports, as well as the oil industry, for example. Forward prices for oil are currently much higher than the spot prices, which means a resurgence in the oil price can be expected soon. Against this backdrop, large, integrated oil companies may offer interesting opportunities for share price gains. A somewhat more speculative alternative would be companies specifically focused on production and exploration as well as oil services. ■

Country	Index	Index level	Expectation	Dividend in %	Price / Book	Price / Sales	Price / Earnings
		17.04.2015	12 months				
Switzerland	SMI	9 246	↗	2.9	2.7	2.3	18.2
US	S&P 500	2 081	→	2.0	2.9	1.8	17.7
Germany	DAX	11 689	↗	2.4	2.0	0.9	15.2
Italy	MIB	23 044	↗	2.5	1.2	0.7	17.3
UK	FTSE	6 995	↗	3.7	2.0	1.1	16.7
China	HSCEI	14 437	↗	3.1	1.4	1.1	9.8
Japan	TOPIX	1 589	↗	1.5	1.4	0.8	15.4

MODULAR CONCEPT "PORTFOLIO OF THE FUTURE"

Diversified and forward-looking

Recommendations for individual portfolios		**Investment instrument**		
		Voralpin traditional	**Alpin** diversified	**Hochalpin** dynamic
	**Liquidity** Unattractive due to negative interest rates - Sufficient cash in home currency for investors for the next two years	3 %	3 %	0 %
	**Fixed-income** Scarcely any yields available – avoid long maturities - Only to smooth out fluctuations - USD bonds and inflation-linked bonds as diversification	38 %	32 %	1 %
	**Equities** Give preference to shares in companies with strong cashflow and sustainable dividend policies - Northern European dividend stocks - Global leaders - Selectively attractively valued emerging market stocks	44 %	44 %	67 %
	**Real estate** Stable returns and dividends - Focus on Switzerland - Singapore, Spain, and Germany as diversification	12 %	5 %	4 %
	**Alternative investments** Use the diversification potential of specialized investment strategies	not permitted	10 %	17 %
	**Precious metals** We regard gold as a currency that no central bank can print	3 %	6 %	11 %
	**Currencies**			
	CHF	71 %	71 %	31 %
	USD	14 %	16 %	40 %
	EUR	4 %	2 %	8 %
	Asia	2 %	5 %	15 %
	Various (NOK/SEK/CAD)	9 %	6 %	6 %

Allocation as of 16.04.2015
Recommendations are subject to change at any time

ATTRACTIVE INTEREST IN ZERO-RATE ENVIRONMENT

There is a safe way of investing your pension assets with positive returns after all

The "Columbus' egg for pensions" was how the Berner Zeitung BZ described this investment idea (03.02.15, page 13). The NZZ was more circumspect – "How to give yourself a mortgage with your own pension assets" – and quotes Jörg Odermatt, CEO of our sister company PensExpert AG: "If you use your retirement assets to grant yourself a mortgage loan, you get the interest on the debt as investment income rather than it going to a bank" (11.01.15, page 37). What are the key aspects of such "self-granted mortgages" and who are they suitable for?

Advantage 1: Mortgage loan with your own retirement assets

In the current zero interest rate environment, it is more attractive than ever before to provide yourself with a mortgage loan from your own pension assets: the title to the property is pledged to the pension fund, which in return grants you a mortgage loan. Or in other words, your retirement assets essentially serve as your own bank, and you grant yourself a loan from your pension account secured against your property. This position is regarded as a loan receivable in your pension account, and is part of the nominal value category bonds. An investment with more attractive interest income, and virtually without counterparty risk since you yourself are the counterparty. Given that the rate of interest is based on variable market rates, the investment is also not subject to any interest rate or duration risks.

Advantage 2: Interest offers two-fold tax advantages

The regular interest payments offer interesting tax advantages. On the one hand, you pay interest on a mortgage loan which you can deduct from your private taxable income. Secondly, these interest payments – currently 2.75 % p.a. – are credited to your personal pension account free from tax, thus directly benefiting your own returns.

Advantage 3: Voluntary contributions are still possible

In the case of an advance withdrawal under the WEF scheme to promote home ownership, voluntary contributions are only permitted again once the advance withdrawal has been repaid in full. With a self-granted mortgage loan, however, voluntary contributions remain possible as before. Furthermore, unlike with a WEF advance withdrawal, interest payments are "due", thus offering the tax advantages outlined above.

Advantage 4: You save on the interest rate margin

Compared with a normal mortgage, one major advantage of a self-granted mortgage is that you can save on the credit margin of the bank or insurance company.

Comparison of different forms of real estate financing	Self-granted mortgage	WEF advance withdrawal	Traditional mortgage
Interest payment tax-deductible	✓	×	✓
Tax-privileged voluntary contributions still possible	✓	×	✓
"Interest paid to yourself" – a tax-free return that benefits your pension account	✓	×	×
Independence from lending bank	✓	✓	×
No interest rate margin to lending bank	✓	✓	×
No financing via debt capital	✓	✓	×

Who is a self-granted mortgage suitable for?

Self-granted mortgages are particularly suitable if you are keen to take on responsibility yourself. Among our clients that avail themselves of this opportunity are law firms, doctor's practices, hospitals, listed companies, small and medium-sized industrial enterprises, etc.

Now is the time to make the arrangements to ensure that tied retirement assets can generate returns despite the negative interest rates, and without you having to take on additional risks. And to ensure that you are set up well for your retirement. Self-granted mortgages are more than just a "Columbus' egg for pensions" as the Berner Zeitung put it – they are your own personal "Fabergé egg" for your individual pension account.

We will be happy to explain this investment idea to you in detail for the extra-mandatory PensFlex solution offering maximum individualization or also for your vested benefits.

Remy Reichmuth, CFA

SWISS INFRASTRUCTURE AS AN INVESTMENT

Attractive investments with high payout yields

Infrastructure is a theme that is often overlooked. Unjustly so, since hospitals, railway stations and sewage treatment plants that are in good order enrich the quality of life. If their maintenance is neglected or they have insufficient capacity, this represents a tangible problem – both for every individual citizen and for the functioning of any economy.

High need for investment

Trends are unleashing inexorable structural change at the global and local levels alike, and these are posing major financial and operational challenges for many countries. An intact infrastructure environment is a fundamental prerequisite for a strong economy. In light of the necessary investment volumes (in the tens of billions), coupled with the more stringent regulatory requirements imposed on lending institutions, it is highly unlikely that this can be financed from the public purse alone.

Public-private partnership

While the lion's share of financed infrastructure projects in the Anglo-Saxon countries are already privately funded, this topic has only come to the fore in Switzerland with the amendment of the Ordinance on Occupational Retirement, Survivors' and Disability Pension Plans BVV2 (Art. 53). With this move, the federal government has pointed the way forward by recognizing infrastructure as an asset class, thus implicitly supporting investment from the private sector.

Attractive investment opportunity

From the perspective of investors, this can only be a welcome development, since the limited investment opportunities amid negative interest rates have long since diminished the appeal of long-term bond investments. At the same time, they have acted as a catalyst for equity investments and real assets. This situation poses new challenges for many investors, but in particular for professional investors who i) need readily predictable payouts and yields with low fluctuation bandwidths, ii) have to keep the correlation with other asset classes low, and also iii) have commitments in CHF. Many pension funds have reacted of late, amending their investment guidelines and opening up their investment universe for the active management of the infrastructure segment.

Experience with real assets

With our forward-looking investment policy, we at Reichmuth have been active in the structuring of investments in real assets since the 1990s. Our attention initially focused on real estate, with the listing of Mobimo AG. The continual expansion of our investment universe led in 2012 to the foundation of InRoll AG, a diversified freight car portfolio, and subsequently to a broadly diversified portfolio covering various infrastructure segments. Our FINMA-regulated fund, which is restricted to qualified investors, was launched at the end of 2014. The initial investments were made in Swiss district heating systems. Further investments will follow in the categories i) transport, ii) utilities / waste management, and iii) social infrastructure. We have a strong team working in close cooperation with proven external specialists, and with the support of experienced directors and investment advisors. Thanks to this collaboration, there is already a considerable pipeline that will be extended and realized going forward.

If you would like more information on this exciting investment theme, please contact Stefan Zumtaugwald or Marc Moser, who will be happy to help you. ■

Stefan Zumtaugwald

Infrastructure investments – core areas

Transport

Land
Rail transport
Municipal bus services
Car parks, railway stations

Water
Ports
Shipping

Air
Airports

Utilities / waste management

Utilities
Generation (electricity/gas/heat)
Distribution (grids)
Efficiency / storage

Telecommunications

Waste management
Refuse incineration
Waste water
Sewage treatment plants

Social infrastructure

Education
Schools / universities
Sports facilities
Cultural facilities

Healthcare
Old people's and care homes
Hospitals
Health centers

Others
Prisons, etc.

Highlighted: Investment themes of Reichmuth Infrastruktur Schweiz KGK

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