Check-Up

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

Editorial

Various upheavals have taken place over the last 100 years. The new world order in the post-war years and the collapse of communism at the end of the 1980s are good examples. The removal of the gold standard at the beginning of the 1970s was also a watershed moment, as was the triumphal rise of the internet during the 1990s.

It is still almost impossible to gauge the effects that the current upheavals will have and what the world will look like five or ten years down the road. Nevertheless, they do happen, whether you like them or not. Our job is to observe them closely with open eyes in order to identify the key drivers and their effect on our portfolio positioning. We look forward to discussing the opportunities and risks presented by the current developments to determine the investment focus that best suits you personally.

Remy Reichmuth,
General Partner

WORLD IN UPHEAVAL

Paralysed central banks

We are living in interesting times. It is actually very rare to witness three significant upheavals at the same time. Today we are experiencing them in global geopolitics, the technological revolution and monetary policy.

1. Geopolitical turmoil

On the global stage, the USA's world dominance is increasingly being challenged by China. This is clearly visible in Xi Jinping's vision for a new silk road, or "one road, one belt". Even if President Trump reaches an agreement with China to reduce the trade deficit, the squabbling over technology supremacy will remain. On top of that, the Chinese are striving to replace the USD as a trading currency in Asia.

Elections are approaching in the West. If President Trump wants to be re-elected in the USA in 2020, the economy will have to be running smoothly. Before that, the less popular European Parliament elections to be held in May will provide the first indication of which way the wind is blowing. The European economy has not managed to shift into high gear despite record-low interest rates and a weak EUR. Brexit is starting to resemble the infamous Hotel California – you can check out but you can never leave. And the Visegrad countries in central-eastern Europe appear to form a barrier between Germany/France and the Russian/Chinese world. Hardly much reason for optimism there. Nevertheless, the good standard of living and comparatively stable democratic conditions in Europe remain attractive for many. Whether this remains the case or whether political upheavals are looming cannot be forecasted today. In the future, Europe will be playing more of a second fiddle on the world stage.

2. Technological revolution

Everyone is talking about digitalisation, and although some of us might be rather sick of the topic, its significance for the rapidly advancing technological transformation is immense. Admittedly, the trend is usually overestimated in the short term, but its long-term effects are often under-

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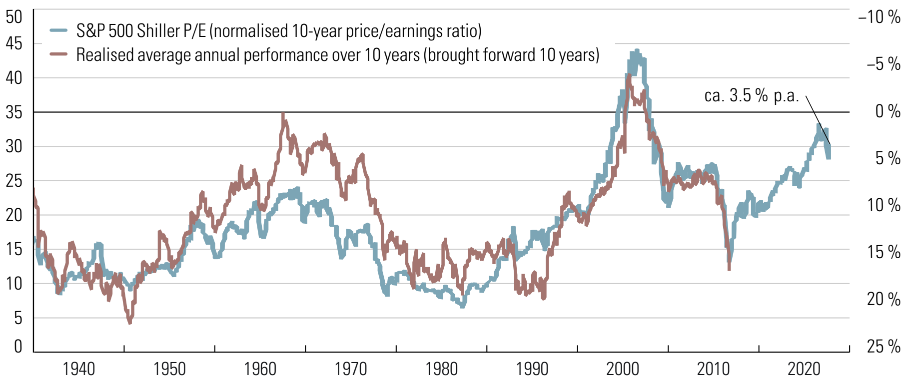
Shiller P/E is a good expectation indicator



estimated. Just like with a daily news feed, we have to differentiate between relevant and irrelevant information. A difficult but necessary endeavour, because even supposedly stable long-term business models might not just be affected but could become obsolete. For example, the automotive industry that is so key to Germany's economy is currently under pressure. In addition to the usual cycles and trade tensions, the structural changes are taking a financial toll. The age of oil has passed its zenith, and electricity appears to have taken over as the fuel of the future. A technological leap of this magnitude requires time. During the transition period, many car owners have doubts and are postponing their purchases and waiting to see what happens.

3. New territory for monetary policy

The greatest surprise of this year was most likely the about-face of the US Federal Reserve regarding the normalisation process of its monetary policy. It does not want to continue reducing its inflated balance sheet. This means that around 20% of US government debt remains neutralised and lies with the US Fed. The large central banks of the world appear paralysed in the face of high government debt and extreme uncertainty due to the above-mentioned upheavals. They are clinging to their core mandate, which boils down to maintaining low inflation and, if possible, full employment. In the aftermath of the financial crisis, central bankers became unbelievably powerful, turning into the most important actors on the global economic stage. However, according to Paul Tucker, there are two prerequisites for transferring power to non-elected institutions. Firstly, an objective is needed that is shared by all, and secondly it must have no distribution effects. Whereas the first condition is met by the central banks, the second comes up short. The extreme monetary policy measures in place since 2008 have indeed had distribution effects. And the latter is a matter of politics in the western world – in other words a democratic process. This is leading to an increasing number of unsatisfied individuals coming up with political proposals. US President Trump's tweets are as clear a sign of this as the Modern Monetary Theory (MMT) that is currently gaining popularity. The number of discontented voices is also growing in Europe, and redistribution effects are becoming visible in the pension system in Switzerland. Monetary policy can buy time with liquidity, but it cannot solve problems.

Can fiscal policy replace monetary policy?

With the global economy weakening somewhat, there is a growing call for fiscal policy to boost growth. The aim is to prevent a recession, with a recession being viewed in the same light as the flu. A virus may infect many, but it will eventually come to an end. Based on the high debt burden, a recession today is as deeply feared as the plague. Of course, a recession would lead to corrections. Highly indebted companies would have to restructure or go bankrupt, which is part of a market economy system. Governments have often tried to plan in growth, with poor results.

What does this mean for you as an investor?

Should you even be investing at all during these large upheavals? Burying our heads in the sand and waiting for something to happen does not make a lot of sense to us. Unfortunately, neither can we shield our clients from price volatility in public markets. However, we do think that avoiding permanent losses whenever possible makes a lot of sense. We see such risks mostly for debt securities from weak governments that do not have their own currency, but highly leveraged companies are also in danger since their assets are at higher risk than their investments.

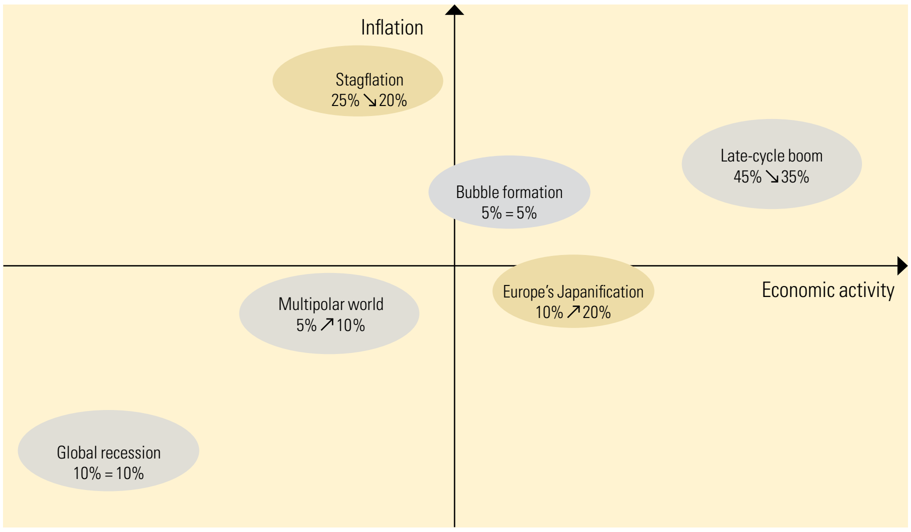
What returns will the future bring?

Since none of the central banks want to make any adjustments to their monetary policy, there are no great changes expected in the short term. Money markets are showing negative returns in CHF and EUR, bonds should return 0%, and stocks are rather expensive. The reciprocal value of the Shiller P/E is a good rule of thumb for predicting performance on the stock markets over the next 10 years. This lies between 3% and 6% per year depending on the region, along with the large fluctuations inherent on stock markets, unfortunately. Thus, the expectation for a traditional 50/50 portfolio (50% bonds, 50% assets) stands at 3% per year. Risk-tolerant and risk-friendly investors can increase this expected value, but they must be willing to accept severe volatility and react in an anti-cyclical style. Or, they can complement their portfolio with solid, long-term-oriented but often illiquid investments.

Christof Reichmuth, General Partner

CENTRAL BANKS TAKE CENTRE STAGE ONCE MORE

Growth fears force central banks to change course



Yellow = the scenarios described below

Summary

- Weakening economic growth is reducing inflationary pressure
- In Europe, a normalisation of interest rates appears very distant, and parallels with Japan are increasing
- Political relationships are restructuring themselves, globalisation is coming to a halt, and strengthened national interests is curbing growth

Stagflation – Central banks counter weaker growth dynamic

Economic leading indicators are pointing to a slowdown in global growth. Central banks around the world are afraid of choking the economic cycle and are expanding their rhetoric even further. Despite full employment in the USA and no immediate signs of a recession, interest rate hikes do not appear to be on the menu. Further talks between Trump and Xi Jinping in Mar-a-Lago will not result in the desired easing of tensions but rather reveal irreconcilable differences. After punitive tariffs are put off once more, they will begin to have an effect later in 2019. This will hamper global trade and lead to higher prices for consumers. Growth will temporarily fall into negative territory and inflation will soar.

20% Probability 3–6 months

Investment ideas

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

Japanification of Europe – Caught in the Japan trap

The economic-political situation in the eurozone is increasingly resembling the situation in which Japan found itself in the 1990s. The extreme monetary expansion in heterogeneous Europe has created certain country-specific bubbles. With the exception of Germany, government debt is growing steadily while balance sheet adjustments in the private sector are only making halting progress. The European Union is blocked politically and will continue to sink into geopolitical insignificance. No one wants to accept inflation or government bankruptcies as the only clear solutions. The eternal "muddling through" approach will result in the centrifugal forces on the European continent strengthening once again.

20% Probability 3–6 months

Investment ideas

- Avoid European banks and domestic market-oriented investments
- Defensive global dividend stocks remain attractive thanks to low interest rates
- Stocks in Asia
- Quality bonds in USD

OUT-OF-THE-BOX – What will happen in the next recession?

Central banks have busied themselves for too long with extending the economic cycle by means of low interest rates. This means that interest rates will be at very low levels when the next recession begins, thus severely limiting any stimulating effects from rate decreases. Monetary policy measures will therefore most likely be replaced by expansive fiscal policy. Helicopter money will once again be in vogue. Consumption is to be stimulated with tax credits. Infrastructure programmes funded by government debt will be implemented, leading to a sharp increase in government debt. Central banks will try to monetise a large portion of the new debt in order to avoid higher interest rates because they would have a negative effect on growth. Tax increases for the rich will become popular to get a handle on the rising government debt. Widespread negative interest rates will also be implemented. A "levy" on cash withdrawals will be introduced to make holding cash less attractive.

LESS GROWTH – MORE STIMULUS

Interest rate markets and stock markets sending contradictory messages

Patrick Erne,
Head of Research

The global economy is slowing somewhat, which is not unusual for a late-cycle phase. Nevertheless, it is surprising how quickly the central banks around the world are responding and signalling their support. Even though keeping some temporary cash reserves seems logical after the steep share price climbs this year, in our opinion it is still too early to assume a more defensive position in light of the worldwide support measures.

Is the political economic blockade easing?

The global economy lost more momentum during the first four months of 2019. Restrained investment and order placements can be clearly felt in certain industries. The number of companies that have already had to lower their expectations for the current year is growing. However, the trade dispute between the USA and China is showing signs of softening. With an easing of the political blockade, we are expecting an upturn in demand, particularly in cyclical sectors. However, individual industries are finding themselves in a structural upheaval (e.g. car industry) or those that are geostrategically significant (technology). A strong headwind will continue to be felt in these industries. Whether or not and how quickly growth in China stabilises will be decisive for the global economy. Tax breaks and a relaxed lending policy have already been introduced, and certain indicators are pointing to stabilisation. Over the next few months, credit growth in China will be the most important indicator of the direction in which the global economy is going. We are optimistic that the political blockade – at least outside of Europe – will ease somewhat, and we expect a stabilisation of growth rates over the next months.

GDP growth expectations	GDP current growth	Growth expectation 2019
USA	3.0%	2.0 – 2.5%
Europe	1.2%	1.0 – 1.5%
Switzerland	1.4%	1.0 – 1.5%
Japan	0.3%	1.0 – 1.5%
China	6.4%	5.5 – 6.0%

About-face on interest rates

The US yield curve has become at least partly inverted. Historically, an inverted yield curve was a sign that a recession threatened and would be contradictory to our economic forecast. Apart from the yield curve, however, we are not seeing any indicators of an acute recession: major currencies are on a relatively stable course, credit spreads on high-yielding bonds remain low, and although commodity prices such as oil have recently fluctuated somewhat, they are nowhere near critical levels.

Interest rate expectations have changed significantly during the first four months of the year. In the USA, no further rate hikes are expected; on the contrary, a rate decrease is already being forecasted. In Europe, a rate increase has been postponed to a future date. Today's market is not expecting an initial cosmetic interest rate hike until 2020 at the earliest and hopes for an end to negative interest rates by 2022! The same applies to Switzerland, meaning that the problem of negative interest rates has grown more acute in our own backyard. Around 60% of all outstanding CHF bonds in the Swiss Bonds Index are yielding negative returns. And once inflation is deducted, there are hardly any qualitatively acceptable bonds that are returning an actual profit. The emerging-market bonds or insurance-linked bonds in the alternative sector that we have been adding to our portfolios are somewhat more attractive. Overall, however, we remain cautious regarding fixed-income investments and are avoiding excessively high credit risks.

Interest rate expectations	3-m rate (Libor)	Expectation in 3 – 6 m	10-year swap	Expectation in 3 – 6 m
USA	2.8%	rising	2.5%	unchanged
Europe (D)	-0.4%	stable	0.5%	unchanged
Switzerland	-0.7%	stable	0.1%	unchanged
Japan	0.1%	stable	0.1%	unchanged

Sell in May and go away?
Due to the weaker economic development, earnings-growth expectations have decreased over the first four months. Nevertheless, the stock market recovered with an impressive rally on the day and has already offset the previous year's losses. The SMI Swiss stock market even achieved an all-time high and is attracting investors with a dividend yield of over 3%. In contrast to the more cyclical small and mid caps, this segment has been spared margin pressure so far. With the negative earnings revisions and the fall in valuations for small and mid caps, we are now seeing a renewed potential for positive surprises from certain companies.

Correspondingly, the mood among stock market investors has switched from pessimism to optimism. And last but not least, the trade dispute between the USA and China is expected to reach a more amicable solution and is currently being factored into share prices to a large extent. Certain elements are pointing to a consolidation in the short term. On a tactical level, we are holding back some cash reserves so that in the case of market corrections we can once again increase the allocation in quality titles with high dividend yields, and we have extended the hedging on the US stock market over the summer.

On a regional level, we continue to be positive about Asia. With the fiscal stimulus in China, an easing of the trade dispute, and the continuing high valuation discount compared with the rather expensive markets in Switzerland and the USA, we foresee further upside potential. With the expected economic stabilisation and minimal inflationary pressure, quality stocks remain the preferred asset class in the medium term.

Stock market	Index level (12.04.2019)	Price / earnings	Price / sales	Price / book value	Div. / yield	Expectation 3 – 6 months
S&P 500	2 907	17.6	2.2	3.5	1.9	sideways
DAX	12 000	13.3	0.9	1.6	3.1	sideways
SPI	11 344	17.1	2.0	2.0	3.0	sideways
TOPIX	1 605	12.6	0.8	1.2	2.3	sideways
China H-Shares	11 660	8.9	1.2	1.2	3.5	rising

In short

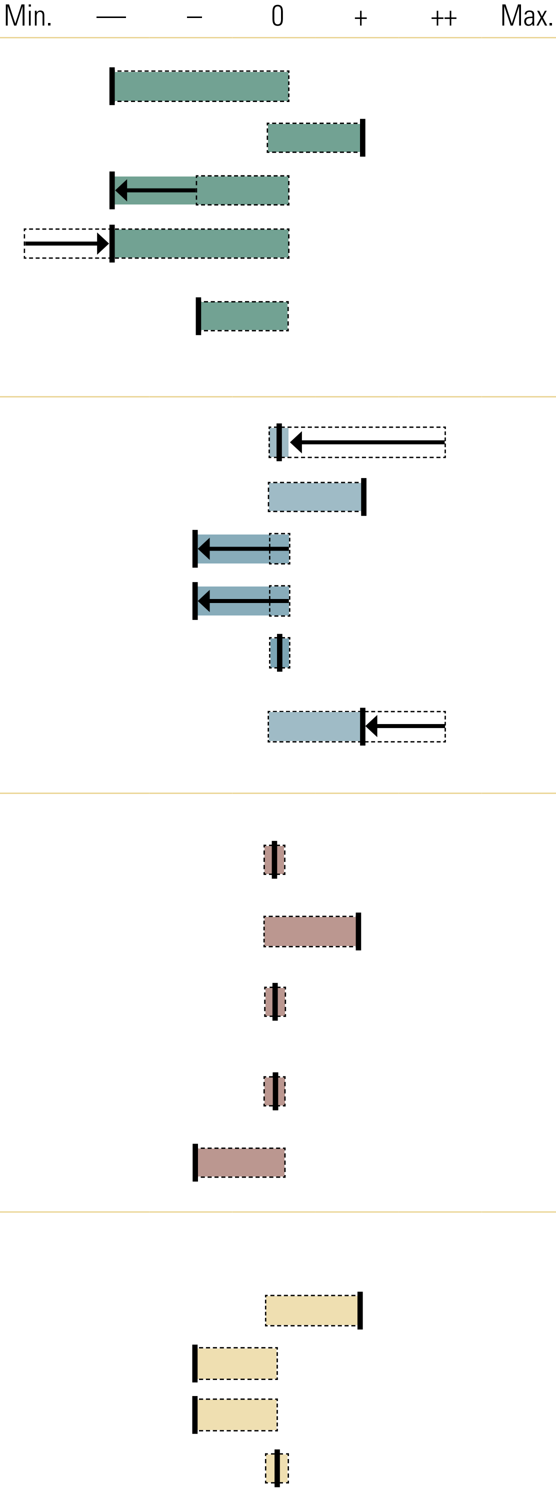
Earnings pressure in negative interest rate environment – What you should be counting on
There is still no end in sight to the negative interest rate policy in Europe, and expectations for returns are sinking. To compensate for this, pressure is increasing on investors to run more risks and make pro-cyclical adjustments to their strategy. What you should look for when selecting investments:

- **Quality:** Anything that yields a positive return looks attractive in a negative interest rate environment, regardless of quality. However, not every company can survive in a difficult economic environment. Quality companies with a solid balance sheet have the best chances of weathering such a cycle.
- **Profitability:** Large amounts of money are flowing into business models that may display strong revenue growth but still have to endure many years of high losses and depend on external financing. Such business models are frequent among IPOs. Instead, look for investments that already have positive cash flows today.
- **Real value preservation:** Today's low interest rates are a blessing for the governments of highly indebted countries. Despite high debt levels, the interest costs to service these debts are barely rising. While governments are profiting from this financial repression, investors in government bonds are suffering real value losses even with low inflation, or they will find themselves faced with an increased restructuring risk in the event of an economic downturn.
- **Diversification:** Don't put all your eggs in one basket. Sufficient portfolio diversification is imperative and applies to investment categories, currencies, regions and individual securities.

INVESTMENT POLICY OVERVIEW

Robust portfolio structure essential in times of increased volatility

Asset class | **Positioning** | **A short summary:**



Bonds

USA

Europe

Switzerland

Emerging markets

The search for positive returns in the fixed-income sector is becoming noticeably more difficult. Another interest rate cut boosted the volumes of outstanding bonds with negative returns to new record levels (> USD 10 trillion) and is lessening that asset class's attractiveness. We are seeing the most lucrative, risk-adjusted yields from US corporate and emerging-market bonds.

Equities

USA

Europe

Switzerland

Japan

Asia/emerging markets

After a resounding start to the year, we reduced the equities weighting slightly with profit-taking from Swiss blue chips. We also purchased put options on the expensive US market.
Our market idea for India has worked very well since its implementation, and we are selling the country ETF in the run-up to the elections at a profit. Asia remains our preferred region, with a main focus on China. We remain neutrally weighted overall.

Alternative investments

Hedge funds

Insurance-linked securities

Raw materials incl. gold/silver

Real estate

This asset class remains attractive thanks to its excellent diversification qualities. During an extended period of growth, active and flexible hedge funds can profit from a greater divergence between quality companies and companies with difficulties. In this environment, insurance-linked securities remain one of the few genuine alternatives with an attractive risk/return profile, and we continue to treat gold as a crisis hedge.

Currencies

USD

EUR

CHF

Other

The interest-rate difference between the USA and the European continent along with slowing global economic growth should initially offer even more support for the greenback, so we are maintaining a slight overweight in USD for now. However, the deficit needs to be monitored carefully.

Previous Current Change

If any of our clients would like to receive a copy of our Investment Policy publication with detailed market assessments, please contact your relationship manager or register with Nadine Vonwyl at nadine.vonwyl@reichmuthco.ch.

INFRASTRUCTURE – IDEAL ADDITION

Proven investment solutions and launch of our second infrastructure fund

After the financial crisis of 2008, spending on infrastructure was reduced within government budgets, leading to an investment backlog that still exists today. According to figures from the World Economic Forum, global spending on basic infrastructure (transportation, energy, water and communication) currently totals around USD 3 trillion annually. However, these investments should be one-fifth higher per year, which is aggravating the investment backlog each year.

Infra gap – Switzerland is not immune

The investment and operational costs solely for the energy transition voted for by the Swiss population in 2017 as part of the "Energy Strategy 2050" total around CHF 200 billion. Without capital and participation from the private sector, it will now be difficult to fund the entire energy value chain from production and storage to distribution of electricity. The need for renovation and expansion is also acute in the area of transportation infrastructure. Rolling stock for transporting goods by rail is outdated, since up until now government railways have provided funding.

Alternative and diversified return drivers

Infrastructure investments differ greatly in terms of their return and risk characteristics, which can resemble everything from real estate to private equity. Existing infrastructure facilities, known as brownfield sites with defensive return/risk profiles and few operational risks, typically offer stable long-term yields and regular cash flows, as well as partial inflation protection. In contrast, investments that are still in the project phase, known as greenfield sites, exhibit a higher return/risk profile. An example would be a yet-to-be-constructed wind park.

In each case, however, infrastructure investments offer an attractive diversification option thanks to their low correlation with traditional capital market investments and are ideal for a typical institutional portfolio with a long-term investment horizon. The following investment features are key for many investors in infrastructure:

- Stable and secure cash flows and returns
- Owning real assets
- Low correlation with other asset classes
- Partial inflation protection

Second fund to be launched based on proven solutions

Over the past seven years we have focused on medium-sized, primarily private-sector-influenced transactions in the areas of transportation and energy. This has also enabled us to make a contribution to upgrading transportation and energy infrastructure together with our investors. We made our first infrastructure investments in the area of railway freight cars. This freight car portfolio, InRoll AG, has grown steadily since then, and today amounts to around CHF 400 million. It has also fulfilled our expectations for stable and attractive returns. At the end of 2014, we founded our first infrastructure fund, which focuses on Switzerland and invests in the areas of transportation, supply and waste management, and social infrastructure. This diversified fund has since made 10 investments and is on the verge of completing its investment phase.

Now the Reichmuth Infrastructure CIP II follow-up fund is coming, which will focus on the transportation and supply/waste management sectors in Switzerland and Europe.

Traffic/Transportation	Energy
- Rail transport	- Electromobility
- Freight cars	- Energy distribution (networks)
- Main-line locomotives	- Energy production
- Shunting engines	- Efficiency/storage
- Logistics	- Waste disposal
- Terminals (transshipment infrastructure)	
- Port infrastructure	
- Public transport by rail	
- Air (freight/passengers)	

CIP II target sectors

It also aims for a comparatively defensive return/risk profile. Qualified investors can use this fund to invest in a widely diversified range of infrastructure segments.

Your client relationship manager is happy to provide you with more information and answer any questions you may have.

Marc Moser,
Senior Relationship Manager Institutional Clients

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"TANGIBLE CLIENT BENEFITS"

Interview with Jürg Staub, General Partner

Jürg, how is business?
After the markets closed 2018 on a disappointing note, things got off to a more positive start in 2019. Our resolve not to get caught up in the short-lived, extremely negative mood at the end of the year has paid off. The portfolios have been able to make satisfactory gains, and I'm also happy with the development of our enterprise. After a very positive 2017, we had a challenging 2018. We're still not halfway through 2019 but the results from the first few months are giving me cause for optimism.

Is the often-mentioned technological revolution affecting you as well?
Of course. And with the many opportunities that accompany it, it is a challenge to set the right priorities. In general, however, if and when it is possible and desirable to differentiate in a sector, we try to achieve it with a maximum focus on our clients. In areas where it's not really possible to differentiate between what is on offer, the primary objective is to increase efficiency. Major upheavals can cause uncertainty, but in my opinion these are tremendously exciting times with a tangible spirit of optimism.

Does this also influence corporate strategy?
Absolutely – and it has done so over the past years as well. In any case, we had already planned to overhaul our corporate strategy for 2019. In concrete terms, we are now accomplishing it in the second trimester in three stages. Firstly, we will be contacting our clients to discuss a handful of key questions. Secondly, we are conducting workshops with some of our employees between 35 and 45 years of age, with the aim of purposefully opening up the field "out-of-the-box" as well. And thirdly, we will then go on a retreat with the management team and rework the strategy.

Are fundamental adjustments planned?
We have always wanted to be an independent and critically thinking market player for clients who view the world the same way we do. Our clients have made us into the bank we are today: a business bank, pension bank, family bank, private bank, infrastructure bank, etc. Our core convictions will always be the same, but the type of banking we will place the most priority on in the long term, based on our clients' needs, remains to be seen. For example, I could imagine that a "Fort Knox bank" with a focus on asset security – or in the age of big data even a sole focus on personal data protection – could make sense in the long term.

Where does the impetus for innovation come from?
None of our innovations in the past years were developed in an ivory tower but rather always resulted from interactions with our clients. This applies both to our highly individualised pension solutions PensFlex, PensUnit, etc., and to our infrastructure investments. Furthermore, within the company we strive to provide a fertile ground for ideas. An example of this is our Accelerator Team, which we initiated in 2018. This prioritises the most diverse opportunities that present themselves and develops concrete solutions. The mandate is clear: Implement IT projects that either a) increase client benefits directly or b) result in process automation. However, in this regard our clients are our main priority as well, and everything we do adheres to our philosophy of preserving what's good and improving what's not.

How does this serve clients in concrete terms?
Ultimately, with tangibly superior benefits! It could be, for example, very down-to-earth solutions for simplified digital communication, such as asset withdrawals via e-Connect, which is also more eco-friendly. Or integrating relevant fintech solutions from third parties. We bring applications on board for clients when we recognise that they will benefit from them. In today's environment with its limitless opportunities, both technological and otherwise, clients are often no longer focused on asset management alone. Instead, they are looking first and foremost for someone who will assist them objectively and with an integral perspective – their own "personal CFO". We are ideally positioned to fulfil this role.

What will the drivers be to ensure that as a private bank you will be able to successfully navigate the upheavals taking place?
A constant focus on client benefits remains our top priority. Secondly, openness and/or compulsion to adapt. And thirdly, having the right employees will be decisive. The current environment offers tremendous opportunities for "products" and "processes". However, no matter how good the solution is, it will come up short if the "people" factor is not spot on.

Jürg Staub,
General Partner