Check-Up

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

Editorial

Resorting to extreme measures five years ago when negative interest rates were introduced, this completely new investment environment was yet to be understood. In other words, a break with the past similar to the discontinuation of the Bretton Woods system in 1971, the effects of which on flexible exchange rates only became clear years later. If negative interest rates become a permanent feature – and are reduced further – what does that mean for investors, the economy, and public policy?

These are the questions we grapple with every day. Central banks appear to have declared crisis mode to be the normal state of affairs. In the face of such uncertain times, personal contact and meetings are great opportunities to discuss your objectives and options. No one can predict the future, but you can always prepare yourself for certain scenarios.

Jürg Staub,
General Partner

HOW CAN YOU INVEST SAFELY?

Negative interest rates mean guaranteed losses

Developments on the world stage are unsettling many investors. Negative interest and more negative interest as far as the eye can see. Investors can barely find bonds nowadays with reasonable quality that do not have negative yields. And that's why there is no simple answer to this simple question.

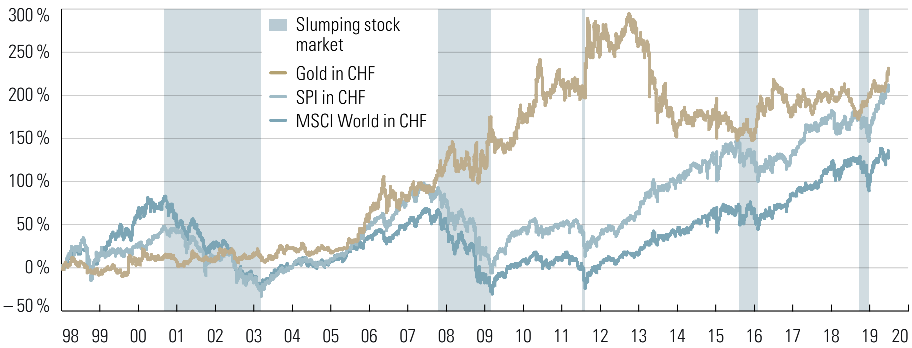
CHIMERICA was the acronym for the symbiosis of the world's two major economies, the USA and China. The global economy was sometimes described as a jumbo jet with two wings that needed each other to propel growth forward. China was the factory, the USA was the consumer. Since Trump took over the presidency, the engines have been stalling, and the jumbo jet has been taken out of service. The US government wants to reduce the enormous trade deficit and is undertaking unilateral measures such as tariffs to achieve this, thereby instigating a trade war. In the past, trade imbalances were corrected by means of currency adjustments. These were often pursued through cooperation among governments and central banks, such as the Plaza accords in the mid-1980s, with both the JPY and the DEM devalued in a concerted effort against the USD. Today, however, such collaborative action appears very unlikely. The US government is operating alone, Germany no longer has its own currency, and China, as an up-and-coming world power, is viewed as an opponent rather than a partner. From the perspective of a small, open national economy such as Switzerland, neither trade wars nor currency wars are a good thing.

Europe under pressure from global and domestic affairs

Brexit is looming large, the new leaders elected to the EU Commission, the EU Parliament and the Central Bank have not yet taken up their positions, and there is often a wide gulf between the interests of north and south, east and west. Fast-

Continued on the next page

Gold increases when equities slump



paced technological development is another factor – and one in which Europe plays a minor role. The German automobile industry is a prime example of just such a sector in crisis. It has been hit hard both by the trade dispute and the trend towards electric vehicles. Over the summer, the most important development in Europe was the strategic move by the French president to insert Ms Lagarde into the highest position at the European Central Bank. In a divided Europe, it will be the European Central Bank rather than the EU Commission that plays the decisive role.

Who benefits from lower interest rates? Who benefits from negative interest rates?

Christine Lagarde is a political star, the complete opposite to the previous technocrats who occupied the top spots at the Central Bank. Hoping that she will keep the Eurozone together and persuade the EU governments to work more closely together in regard to monetary policy, some have welcomed her appointment. As a result, monetary policy experiments may become even more widespread. Fiscal policy will be given even greater importance. Negative interest rates have already become a type of redistribution mechanism from north to south. Who benefits from even lower interest rates, and above all who benefits from negative interest rates? In times of crisis, a central bank should ensure there is sufficient liquidity. It can lower interest rates to zero, but anything lower poses significant risk! Would it not be smarter to leave interest rates at zero until the economy strengthens again and inflation can be observed? Borrowers with good credit ratings can finance themselves cheaply, i.e. almost for nothing, while weaker ones would have to pay a higher risk premium. This is how a disciplined market works. Slight deflation would have to be acceptable, as would slight inflation. Interventions would only be undertaken in the event of a new financial crisis, with the newly created instruments, including bank liquidation, intervening. Would that not re-establish trust in the future? New experiments only create more uncertainty! We hope that Ms Lagarde will do what is right for the long term instead of choosing short-termism. In our opinion, the chances of this happening are poor. Perhaps it's time to purchase more gold.

Does gold strengthen a portfolio?

There is hardly a more controversial investment than gold. Some consider it a barbaric relic, while others see it as a value-retaining currency with no counterparty risk. The world as it is today, in our view gold makes sense on many levels. Firstly, negative interest rates are positive for gold. Secondly, gold has no actual counterparty risk, as it cannot be manufactured or destroyed by humans. And thirdly, gold is viewed as an insurance against stock-market crashes (see box on page 5).

Signs point to "carry on as before".

Everyone seems to be trapped in their roles and are holding fast to their mandate, meaning that things are most likely to stay the same. This will continue until an external shock puts an abrupt end to this approach. What could bring this about? Brexit may not be enough in itself. The introduction of a parallel currency in Italy is more likely, as is an oil price shock, a technological blackout or a possible military conflict between China and Taiwan. Since we cannot predict anything, we advise that portfolios are constructed robustly and that you tailor them to ensure that you remain capable of acting in any situation.

So how can you invest (more) safely?

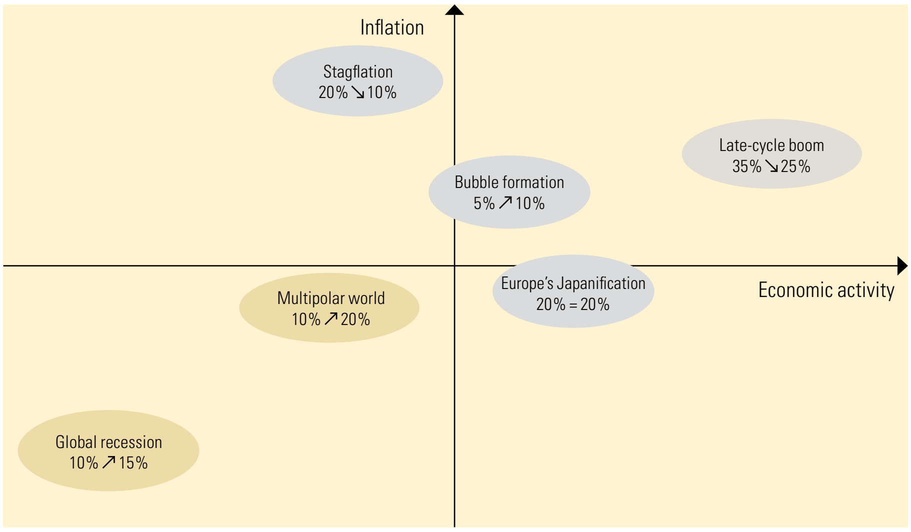
Investing more safely is a question of perspective and depends on the intended use of your assets. If safely means no fluctuations, the only alternative would be cash. However, you would have to pay negative interest rates in the case of larger volumes. There are still banks that do not charge negative rates up to a certain amount. We always recommend maintaining sufficient cash reserves, generally as much as you would need to cover the next two to three years. This protects you from when markets weaken. Unfortunately, anything other than cash is less safe – at least for those who equate price fluctuations with insecurity. Share prices fluctuate, just as prices for precious metals, alternative investments, real estate and bonds do. We continue to recommend diversification. Differentiate between definite losses and price fluctuations. Ten-year Swiss government bonds are currently yielding –1% annually. For every 100 francs that you invest, you will receive 90 back in 10 years! That represents a definite loss. Admittedly, stock prices do fluctuate. Some companies continue to pay attractive dividends. A 3% dividend per year is 30% over 10 years. The fluctuations may be higher than those of federal bonds, but the risk buffer of both of them together still amounts to around 40% compared over 10 years.

Christof Reichmuth,
General Partner

OUR SCENARIOS

Silvan Betschart

Manufacturing industry in downturn – Service sector stable



Yellow = described scenarios

Summary

- Manufacturing industry and yield curves indicate higher risks of recession
- Growth slowdown and oil-price correction lessen inflation risks
- Hardened positions in the trade conflict speed up multi-polar development

Multipolar world – Reorganisation of political power structures

The Trump administration is not holding anything back in its efforts to put the brakes on ambitious China's economic upswing – especially in the area of technology supremacy. The widespread global solidarity seen at the beginning of the Great Financial Crisis has dissipated. In the meantime, fierce protection of regional interests now dominates. The USA is doing everything in its power to strengthen its own industries through protectionism. Europe is at a standstill, blocked by domestic politics and playing an ever-diminishing role in global trade. The confrontations with the USA may have stopped China temporarily, but it is increasing its attempts to bolster trade relationships within Asia.

20% Probability 3-6 months

Investment ideas

- Select shares attractive
- Quality bonds and government bonds in USD
- Avoid exposure to European domestic market
- Alternative investments attractive

Global recession – Currency war possible trigger

A destructive currency war is another factor challenging the now fragile world economy. The Chinese government is countering further trade tariffs with additional devaluations of the RMB. This is leading to payment defaults among companies with high debt loads in USD. Global growth is stalling, resulting in the Federal Reserve also lowering interest rates into negative territory in order to weaken the USD and stimulate economic growth. Massive interventions are leading to a global currency war, in which Switzerland holds a poor hand of cards due to its heavy dependence on exports, solid public finances, and strong legal certainty.

15% Probability 3-6 months

Investment ideas

- Overweight cash
- Underweight shares
- Overweight fixed-income investments
- Overweight gold, CHF

OUT-OF-THE-BOX – What if the political elite did the right thing?

After five years of negative interest rate experiments with widespread positive effects for the real economy, the political elite also come to the conclusion that little has been achieved apart from increasing imbalances and gigantic debt loads. Interest rates are initially set at zero and then raised gradually. This protects pension funds from being bled dry. Capital regains its value and is once again implemented more efficiently. A corrective process begins, which less solvent companies will not survive. Certain asset-price bubbles, mainly among nominal assets, implode. The structural correction leads to rising inflation, which helps real debt reduction. Progress is also made politically. Heads of government realise that uncertainty and tariffs are damaging for everyone. Europe also makes strides. Individual countries leave the EUR, and Germany accepts that higher deficits are necessary to keep the EUR project alive.

DEMAND BACKLOG

Signs of recession in industrial sector

Patrick Erne,
Head of Research

Economic growth is continuing to slow. The industrial sector is particularly vulnerable in the trade dispute and is showing signs of recession. However, the central banks' announcement of lowering rates is proping up consumption and preventing highly leveraged companies and states from falling into a debt spiral.

Despite slower real growth, demand for investments with positive yields should keep asset values high.

Manufacturing industry in crisis

Global economy continues to lose impetus. Thus far, the downturn has been felt most strongly in the manufacturing industry. Depending on the sector, order intakes have been weak, and many companies are holding off on investments due to the uncertain geopolitical situation. Countries like Germany, with a high concentration of industrial sectors, are particularly affected. Weakening demand is hitting industry at an unfavourable moment. Salaries in some areas are rising. Structural changes are coming in certain key industries, such as the automobile sector, which require large additional investments in research and development. The longer demand remains weak, the stronger the pressure will become on margins. Such cycles are actually not unusual in the manufacturing industry. Backlogged demand can lead to increased demand in the future. This often happens very rapidly and can result in earnings returning to normal quickly. Key leading indicators are still not showing any bottom formation. In light of the looming geopolitical uncertainties, delays in the global supply chain, and technological advances, the risk exists that the downturn in manufacturing will worsen. Until now, large-scale waves of redundancies have been avoided, and the record-low interest rates in many places are helping heavily indebted companies to service their debts. For the moment, this means there is a low risk of contagion for other industries, particularly in the consumer and service sectors. Growth should remain slow, however, and countries such as Germany may experience a mild recession.

GDP growth expectations	GDP current growth	Growth expectation 2019
USA	2.3%	2.0%
Europe	1.1%	0.8%
Switzerland	1.4%	1.0%
Japan	1.2%	1.0%
China	6.2%	6.0%

Global interest rate stimulus

The US Federal Reserve has undertaken the most drastic aboutturn in its monetary policy, and the key interest rate was lowered 25 base points to 2% for the first time since the beginning of the cycle of rising interest rates. US 10-year interest rates have fallen around 100 base points to 1.7%, resulting in the US yield curve becoming clearly inverse over the past weeks and sending out warning signals of a looming recession. In addition to the initial key interest rate reduction, the QT programme was also stopped. At the same time, the US fiscal deficit is growing continuously, and the demand to boost the economy by printing more money is finding supporters among populist politicians (MMT). It appears to be a matter of time before the Fed resumes its bond buying program. The trend in the USA is symptomatic of the situation in the rest of the world. Debt loads are rising in all regions, both at the government and corporate level.

Despite increased indebtedness and weakening growth, almost all of the fixed-income and credit markets are relatively stable and very little stress can be observed. The risk premiums for corporate bonds have remained almost identical this year. Bonds with positive yields are still a rare commodity, particularly in Europe and Switzerland, and as such are in high demand – despite questionable quality at times.

Interest rates should sink further worldwide. In the USA, there is definitely scope for lowering the key interest rate, and this is bound to be utilised by the end of the year. Some emerging economies also have sufficient leeway to lower rates due to low inflation. In Europe and Switzerland, real yields are already clearly in the negative zone despite low inflation, and depositors are suffering real purchasing power losses. Through the redistribution effects of negative interest rates, public pressure on politicians should continue to grow, making it difficult to find majorities in favour of reforms. This means that a further escalation of negative interest rates in Europe is probably the only feasible path in the short term. In spite of the sinking interest rate trend, bonds remain an asset class but are unattractive as a whole. Quality bonds in Switzerland and Europe have zero or negative yields, and we recommend against making any significant compromises when it comes to quality. In our opinion, USD bonds from quality companies and certein emerging economies offer the best risk-return profile.

Interest rate expectations	3-m rate (Libor)	Expectation in 3 - 6 m	10-year swap	Expectation in 3 - 6 m
USA	2.1%	lower	1.5%	lower
Europe (D)	– 0.4%	lower	– 0.3%	slightly lower
Switzerland	– 0.8%	lower	– 0.6%	slightly lower
Japan	– 0.1%	unchanged	– 0.1%	unchanged

Realistic earnings expectations?

Although earnings expectations have been revised downward for some months now, earnings estimates for shares in 2020 still remain ambitious. Based on consensus estimates, earnings for the US stock market should experience single-digit growth in 2019 and return to double-digit growth starting next year.

In certain cyclical sectors especially, visibility is currently low and earnings expectations uncertain. The falling oil price is narrowing profit margins for energy shares. With declining interest rates, earnings for banks should rebound, especially in Europe. Furthermore, in the industrial sector, the investment backlog and decline in orders could hit results harder than expected at the moment. So over the course of the next few months we will be giving preference to less cyclical, large cap, quality companies with attractive ongoing dividends. We believe that earnings expectations in this area have a better supportive base. The risk premium for shares remains overall attractive. The interest rate situation is shoring up share valuations despite an economic downturn, so we are still favouring shares over bonds. However, due to the signs of a looming a recession, we are hedging part of the share quota with put options.

If the demand backlog in the manufacturing industry eases over the coming months, then cyclical shares from Europe and Asia would be particularly worth buying. In addition, small cap companies have performed significantly weaker than large caps in the past months. If you have a long enough time horizon and can tolerate greater fluctuations, there are buying opportunities available to you right now in these segments.

Stock market	Index level (16.08.2019)	Price / earnings	Price / sales	Price / book value	Div. / yield	Expectation 3 - 6 months
S&P 500	2,918	17.5	2.1	3.3	2.0	sideways
DAX	11,563	13.7	0.8	1.5	3.4	sideways
SPI	11,827	18.1	2.0	2.2	3.0	sideways
TOPIX	1,485	12.1	0.7	1.1	2.6	sideways
China H-Shares	9,964	8.1	1.0	1.0	3.9	rising

In short

Does gold make a portfolio more secure?

During the last major stock market corrections, bonds and gold were excellent diversifications for a mixed portfolio. Whereas bonds were still the better hedge during the 2000 crash, gold is now king in the era of negative interest. It is intuitively logical, since bonds with negative yields can hardly achieve gains in downturns. Furthermore, there is a limited supply of gold, while the bond offering is growing quickly with the increasing debt loads around the world. If the central banks adhere to their policy, we also expect better diversification effects from gold than from bonds in the future.

	01.09.2000-11.03.2003	12.10.2007-27.02.2009	22.07.2011-10.08.2011	05.08.2015-11.02.2016	01.10.2018-25.12.2018
MSCI World (TR)	– 59%	– 55%	– 25%	– 17%	– 15%
SPI	– 54%	– 48%	– 21%	– 19%	– 10%
Gold	– 2%	+24%	– 1%	+ 14%	+ 7%
Swiss Bond Index	+21%	+5%	+2%	+2%	+1%

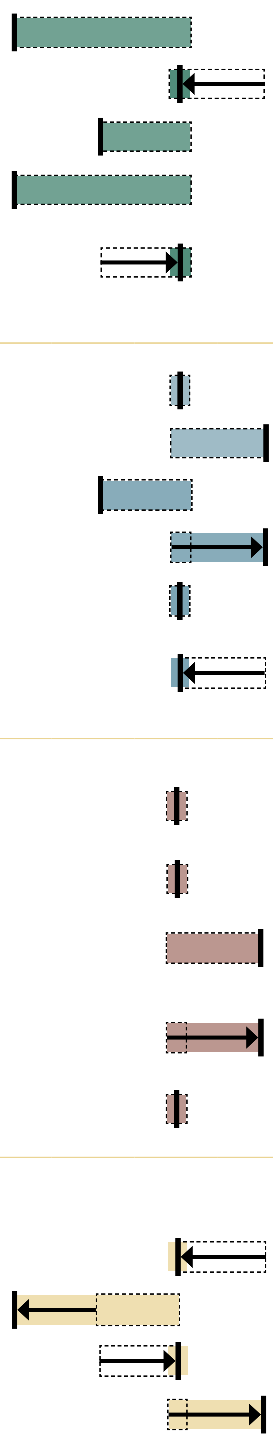
INVESTMENT POLICY OVERVIEW

Cajetan Bilgischer

Alternative Investments offer greater diversification

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

Min. — – 0 + ++ Max.



Bonds

USA

Europe

Switzerland

Emerging markets

With the first key interest rate cut for more than 10 years, the Fed has firmly boxed the international financial community into a low or negative interest rate environment. As a result, the yields on many government bonds have plummeted, with the US yield curve now inverse. We sold US corporate bonds in favour of emerging economy bonds. Overall, bonds remain an unattractive asset class.

Shares (partially hedged)

USA

Europe

Switzerland

Japan

Asia / Emerging markets

Based on the potential escalation of the trade dispute and a possible intensification of negative interest rates in Switzerland, we have increased the home bias for shares at the expense of Asia. Asia is facing a strong headwind in the short term, and we consider Swiss dividend stocks as the main beneficiaries in Switzerland's interest rate landscape. We continue to view hedges on US equities as interesting, and favour more defensive sectors.

Alternative investments

Hedge funds

Insurance-linked securities

Raw materials incl. gold/silver

Real estate

Intensifying geopolitical tensions as well as relatively high stock market values based on historical comparisons are making alternative risk premiums noticeably more attractive. The markets' vulnerability to fluctuations has increased significantly, although more extreme price movements on the currency front offer opportunities for flexible macro investors. Based on the growing probability of a currency war, we have recently increased the gold allocation slightly.

Currencies

USD

EUR

CHF

Others

A global currency devaluation competition would be a lose-lose situation for everyone. We are lowering the foreign currency risk in favour of our domestic currency and gold by further reducing the European common currency and USD. In view of the residual risk of an oil price shock, we are raising the NOK allocation.

Previous Current Change

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

YOUR OWN PENSION PLAN OFFERS RETURN POTENTIAL

Improve results by using tax advantages and minimise risks

Individual occupational pension plans are currently offering one of the most attractive opportunities to ensure returns. A careful and far-sighted optimisation will pay off – especially in today's negative rate environment.

Voluntary purchases smooth the way

Voluntary purchases are the key to pension plan optimisation.

1. They strengthen your personal pension provision and reduce taxable income one-to-one.
2. The dividends and interest income you receive are not subject to income tax in the BVG. This is not the case for private assets, which furthermore are subject to an annual wealth tax.
3. Upon your retirement, a reduced capital tax rate is applied when you withdraw pension capital. Often, gradual withdrawals are also recommended, resulting in even greater flexibility and tax advantages.

2% in the BVG corresponds to 8.7% in private assets

If you decide against voluntary purchases and do not use their tax advantages, an annual return of 8.7%* on private assets would be necessary in Lucerne, for example, in order to amass the same capital over 10 years that you would with 2% p.a. from your pension plan. With the income-tax exemption for dividends and interest income from your pension plan, the difference becomes even greater.

** parameters corresponding to sample calculation below.*

Positive earnings, even in negative interest environment

This is a possibility within the pension provision for those with mortgages. You must replace the banking role with a mortgage from the mortgage fund. With your pension assets (max. 50%), you can subscribe to shares from this fund and thereby replace your current mortgage with the bank. This position is a component of the "Bonds" nominal value category and offers a secure interest income that is currently 2.55% p.a.! The duration risk is low because the interest is in accordance with the variable market rates.

Interest payments offer double the tax advantages

The annual interest payments offer pension beneficiaries tax advantages: Firstly, you can deduct the mortgage interest you have paid from your taxable income. Secondly, the interest credits from the mortgage fund are considered tax-exempt in the personal pension deposits, which directly benefits the return.

Purchases are still an option

In the case of an advance withdrawal to finance your primary place of residence, voluntary purchases may only be resumed once the advance withdrawal has been repaid in full. Voluntary purchases in the pension provision for financing via mortgage funds remain possible.

Better to amortise indirectly rather than directly

In the case of direct amortisation, the annual amortisation contribution cannot be deducted for tax purposes. And it gets even worse: The instalment usually has to be financed from your income, which has in fact already been taxed as income. Mortgage holders can deduct their pension plan purchases from their taxable income and thus amortise their mortgage through their own pension provision.

Pensions Germany

These remarks relate to the general conditions (pension provision and taxes) in Switzerland. PensExpert Germany also offers tailor-made pension solutions with attractive advantages.

We would be pleased to discuss your personal situation and examine possible solutions.

Sample calculation "Advantages of indirect amortisation"
Mortgage CHF 500,000, amortisation period 10 years, annual amortisation or purchases of CHF 50,000 p.a., marginal tax rate 35%, mortgage interest 1%, interest on pension assets 2%, capital tax upon withdrawal 8%

	Direct amortisation (bank)		Indirect amortisation (2nd pillar)	
Amortisation instalments over 10 years × CHF 50 000	CHF	500 000	CHF	500 000
Mortgage interest	CHF	27 500	CHF	50 000
Tax savings on deduction for debt interest	CHF	– 9 625	CHF	– 17 500
Performance credit 2nd pillar (tax-exempt)			CHF	– 47 489
Tax savings on deduction for pension fund purchases			CHF	– 175 000
Capital payment taxes			CHF	40 000
Total costs	**CHF**	**517 875**	**CHF**	**350 014**
Advantage of indirect amortisation:			**CHF**	**167 861**

Marco Danelli,
Pension and taxation expert

Klimaneutral
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"NEGATIVE INTEREST ENVIRONMENT IS CHALLENGING"

Interview with Remy Reichmuth

How are your clients reacting to continues negative interest rates from the SNB?
It's true that most banks are being increasingly strained by negative interest rates. Many clients are finding it hard to have to pay interest on liquidity. Their reaction is often "I would rather invest that money in real estate or a solid stock!" This has caused prices to climb. The SNB policy sometimes forces investors into taking risks that they would normally not consider. This worries me.

How do you as a bank deal with the SNB's policy of negative interest rates?
It's a challenging environment for a private bank. We act as an investment advisor – and that's why our clients choose us. In an investment portfolio, a liquidity ratio of 5 - 10% is completely acceptable.

And if someone wants to invest in mainly liquid funds?
Since we are not a credit or deposit bank, that rarely happens. There are isolated cases of clients depositing high amounts of cash with the aim of profiting from our unlimited liability. In such a case, we explain that the negative interest rates enforced by the SNB will continue to be applied correspondingly to the client's money.

Do clients understand this?
Yes, usually. After all, our liquidity is held by the SNB as that offers the greatest security. And it's clear to our clients that it would be illogical if we made ourselves personally liable for the money on our balance sheet and also assumed the interest charged on this money by the SNB.

Are there any other solutions?
Our core business is wealth management in traditional investments, but we have always sought out innovative niches that make interesting additions to a portfolio, such as infrastructure investments in railroads, energy, waste disposal, etc. These deliver attractive yields and easy-to-forecast, strong cash flows.

Can any client invest in these areas?
No. Initially, there is usually an issue with minimum investment amounts, making it accessible to qualified investors only. However, we are working on being able to offer more liquid solutions as well or this type of investment but in smaller denominations.

Does this also apply to agricultural investments in Australia?
It does, but that's a very specific area. The advantage of agricultural investments is that these hardly ever correlate with volatile financial markets. With the global population expanding, fertile cultivated land remains a limited commodity. In a world of unlimited money printing and record-high debt, agricultural assets offer natural inflation protection in addition to solid free cash flows.

With attractive yields?
Our CEO, Jürg Staub, has been investing in dairy farms in the Australian state of Tasmania for several years both personally and in cooperation with clients. The expected free cash flows in AUD of 3 - 6% p.a. or returns of 6 - 12% p.a. have been validated over this time period. Jürg has been involved in this segment for years with great passion and enthusiasm – and our local network of reliable and competent partners is a result of this endeavour.

Is this a way to avoid negative interest rates?
Both infrastructure and agricultural land are ultimately only additions to a portfolio. Although they offer attractive yields with comparatively low fluctuations, they also come with risks – even though these are different from those of the stock market. If you want to avoid negative rates, it is impossible to avoid taking on additional risks. A key factor for success is identifying those risks (see table). This enables you to diversify them in your portfolio – which is the most sensible response to the current environment, in my opinion.

Risk	Measure	Risk / return profile	Summary
Raised interest risk	Longer duration	Will be poorly rewarded, makes sense depending on liability structure	
Raised credit risk	Lower ratings / poorer credit quality	Only very selectively advisable Credit quality has worsened	
Raised fluctuation risks	More quality stocks	Sensible, but investors must be able to assume fluctuation risks	
Raised liquidity risks	Alternative / unlisted investments	Selective, e.g. infrastructure, Agricultural investments in Australia	
Alternative risk premiums	Add low correlated investments	Gold, hedge funds and insurance-based solutions as diversification	

Remy Reichmuth, General Partner