CHECK-UP

January 2022
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Reichmuth & Co Private Bankers

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Editorial

We wish all our readers a healthy and a happy new year.

Governments and central banks have been able to wield ever greater influence over the past decade, and this will continue to be the case in 2022. The former will vacillate between pandemic restrictions and openings, while the latter will try to detect positive signs of the recent more pronounced fall in the value of their currency.

Financial repression will clearly remain a feature in 2022 and real interest rates will be negative. It will be a tough environment, especially for investors with little appetite for risk. Only cash offers protection against high volatility, but negative interest rates and inflation are gradually undermining the goal of preserving value. In this Check-up, you can find out how to tackle this problem in your specific situation – it's also well worth arranging a meeting to find a suitable solution together.

Jürg Staub
General partner

Inflation, finally …

For more than a decade, central banks fought the threat of deflation with all the means at their disposal. Their arsenal ranged from ultra-expansive monetary policy with zero or even negative interest rates, to calls for expansionary fiscal policy and bond purchases on a massive scale. Nothing seemed enough to yank inflation back up to the targeted 2%. It only came about when the coronavirus pandemic effectively slammed the brakes on the economy and governments responded with an unprecedented package of support measures. Money burst into the real economy to crash against a dysfunctional supply side.

Sand in the gears

Globalisation has brought incredible gains in prosperity over the last 40 years. Everything was optimised, and ran largely like clockwork. But a virus has showed us just how fragile such a high-performing system actually is.

You can't simply switch an interconnected and finely tuned economic system off and on. The market economy can undoubtedly solve the supply problems if it is allowed to. But there are questions that need to be asked here.

Geopolitics is redefining supply chains
Increasingly fierce competition between the world powers USA and China is propelling many companies to adapt their business models. New suppliers are being sought in other regions, especially those closer to home, and security of supply has become more important. Costs are fading into the background.

Climate change is pushing up costs
The restructuring of the energy supply, which is being driven forward in Europe in particular, is capital-intensive and requires large amounts of raw materials. At the same time, the increasingly strong trend towards ESG (environment, social, governance) is hampering investment in mines, so the worry is the energy transition will be even more expensive than expected. As a consequence, energy, a key input factor for the economy, will become more expensive in the long run.

Labour should also be better remunerated
Another cost driver is wage costs. With inflation at around 4–6%, who can say no to workers in the US or Europe asking for higher pay to compensate for this? With discussions about inequality raging, political support for a higher minimum wage to prevent further social unrest is gaining ground.

Will inflation put the brakes on government spending sprees?
Keynesian counter-cyclical fiscal policy suggests governments should run deficits in hard times and cut them back in the good ones. Modern monetary theory (MMT), popular especially in left-wing circles, goes much further. It argues that a government can permanently spend more in its own currency than it takes in and fund the difference with debt as long as inflation remains low. So the only restriction is inflation. And it's here now. But there are no signs yet it will get governments to call time on their spending sprees.

Deflation and crisis are over
It is unclear how to solve the monetary policy conundrum. Clearly, ultra-expansive policy can no longer be justified by the need to tackle the crisis or the threat of deflation. So the hope remains that inflation will come down of its own accord – through the power of the market economy.

> **"Our focus is not on the actual inflation figures, but on the question of whether expectations remain well anchored."**

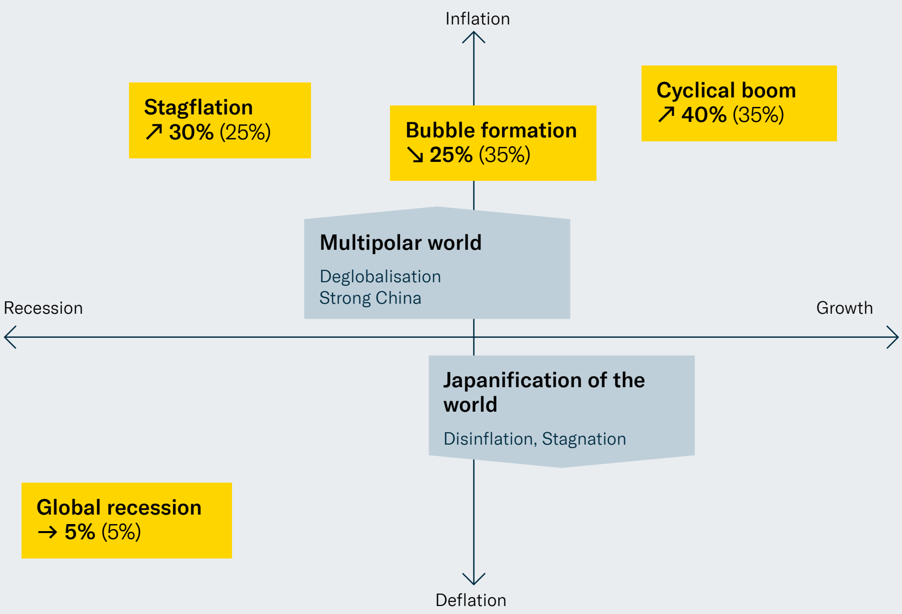
Core indicator inflation expectations
Critical for financial markets will be the responses of central banks and long-term yields to inflation expectations. Should this anchorage loosen and inflation expectations rise, then we can expect stronger central bank measures, i.e. hikes in interest rates. In the absence of this, long-term yields are likely to climb, making us more cautious about risky assets such as equities. From a Swiss perspective, there is almost no need to worry that inflation in Switzerland will rise sharply. The Swiss National Bank's policy is as clear as ever: keep prices stable. But for financial markets, what counts is the situation in the USA and Europe. Should these markets come under pressure due to the above developments, financial markets in Switzerland will inevitably be affected.

Intact opportunities for a good investment year
2021 was a very good year for investors, although performance varied greatly by region and by sector. As long as inflation expectations are anchored below 3%, we see opportunities for 2022 too. But the risk of a correction has increased. What makes most sense in an environment such as this is a well-diversified portfolio geared to the investor's specific life situation and time horizon. Bonds remain the least attractive investment. With equities, investors would do well to seek a balanced mix between defensive companies, i.e. those that benefit from a period of modest levels of inflation, and companies that spur rapid technological development. But a lot of this potential has already been priced in in the latter case. Gold seems to us to be a worthwhile addition, especially in the current environment. Those who think long term can contribute to the decarbonisation of the economy by gradually building up illiquid infrastructure investments. In return, they will be rewarded with relatively attractive cash flows.

Christof Reichmuth
General Partner

Our scenarios

Growth continues, but at a slightly slower pace



Current assessment

- Growth rates to remain above average in 2022 too
- Companies in good shape and with full order books
- Recovery positive for earnings momentum for now – rising risk of overheating in second half of the year
- Infrastructure programmes having positive impact on growth
- Inflation worries becoming more real

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

In Focus: “cyclical boom” scenario

World keeps turning

New coronavirus variants may be prolonging the pandemic and triggering short-term uncertainty in the markets, but they cannot break the broad growth trend. Widespread lockdowns are off the table and the population is learning to live with the virus and periodic boosters. In the US, consumption is still strong and the services sector in particular is experiencing a marked recovery. In Europe, negative headlines are giving way to positive growth drivers, and China is countering the concerted slowdown in growth with supportive measures on the monetary and fiscal policy fronts. All in all, these are encouraging prospects both for global economic growth and stock markets – as long as the economy does not overheat and force central banks to withdraw the punchbowl prematurely by raising interest rates.

Investment ideas

- Overweight shares (give preference to growth stocks)
- Pandemic losers (energy, travel and Japan)
- China with catch-up potential
- Avoid interest rate risks

OUT-OF-THE-BOX

Scenario: fast forward to galloping inflation

With the expected easing in inflation, the biggest central banks are sticking to their loose monetary policy and being left behind by the growth in consumer prices. Although the temporary drivers of inflation will fade in 2022, it is the long-term factors (e.g. chronic underinvestment in fossil energy sources, massive expansion in the money supply and big budget deficits) that will help stoke uncontrollable inflation. Added to this are geopolitical disputes that have the potential to set off the proverbial spark in the powder keg and force central banks to push up key interest rates despite the huge mountains of debt.

Investment ideas

- Defensive shares
- Prefer value to growth
- Keep Swiss currency share high (CHF)
- Gold

Cajetan Bilgischer and Silvan Betschart

Regime change

How fit is your portfolio for inflation?

2022 is looking to be a year of transition: the extreme distortions caused by the pandemic should slowly normalise. Initial above-average economic growth will return to the mean, and interest rates will continue to move away from pandemic-induced lows. The environment is still favourable for equities. But after the strong price rises in 2021 we are expecting some consolidation and smaller price gains. Inflation will remain the dominant issue in financial markets. Even if the reported inflation figures undergo a modest easing in the course of 2022, there are many signs pointing to structurally higher inflation in the coming years. Portfolios must be geared towards this over the long term.

Start of interest rate hikes

Even though inflation expectations are baked in firmly in most currency areas, more and more central banks are preparing for some tightening in monetary policy. Besides the UK and Canada, base rates are likely to be raised in the USA in 2022. We forecast this will happen in the middle of the year, with hikes coming slowly and in small steps. In the risk scenario, these will take place faster and in bigger steps than expected in the market today. Should this scenario manifest itself, it would be an opportune move to temporarily cut risk. In Europe (and Switzerland) we still consider key rate hikes unlikely this year. Even after the first interest rate hikes, real interest rates will remain deep in negative territory in most currency areas, even in long maturities. The expected return on bonds is below future inflation expectations in most scenarios. So minimising risks (going for short maturities and good quality) will take precedence over optimising yields here. Since most currency areas also face higher inflation than Switzerland, foreign currencies currently offer little potential from a CHF investor's perspective.

Business models with inflation protection

With the economy recovering, we are expecting most companies to post solid sales growth. But not all companies will digest rising costs equally well, and some will feel increased pressure on their margins in 2022. Cash flow-strong quality stocks of global market leaders with high pricing power are therefore still the number one choice. As the valuations of many of these companies are high, it is important to diversify in a discerning way here and also include more defensive business models with lower valuations.

Staying with cyclicals

Bank and commodities are equities that do well in inflationary times. Although these are very cyclical business areas, these shares are not just good for diversifying in the current environment. Banks benefit directly from rising interest rates as they can achieve a better interest margin when the economic situation is favourable. And rising commodity prices are an important driver of inflation. Cash flows of commodities companies increase as prices advance. Today's oil prices have hardly moved the dial on the valuations of companies, especially in the energy sector. In the services sector, normalisation has not yet taken place in the travel and entertainment industry. With the last correction brought about by Omicron, there are attractive entry opportunities here.

> **"Alternative investments are displacing bonds as a means of diversifying portfolios."**

China has had a difficult year, and unsettled international investors with wave after wave of regulatory initiatives. With a somewhat friendlier policy mix, we see potential for a recovery in 2022. Europe would particularly benefit if China were to stabilise. With the steady stimulus from the European Recovery Fund and heady levels of investment in the energy transition, we expect Europe to rack up some significant growth, and this should also be a shot in the arm for stock markets.

In 2022, we see risks with highly valued growth stocks whose cash flows are still well into the future and stocks that have been boosted in a big way by the pandemic. We are also cautious about equities used as a substitute for bonds but which are not growing and are holding a lot of debt on their balance sheet.

Don’t put all your eggs in the equity basket
Getting the portfolio composition right is becoming increasingly challenging. Fixed-income investments do not offer the desired levels of diversification in an inflationary world. And investors who put all their eggs in the equity basket are exposed to increased volatility. That is why alternative investments are becoming increasingly important. Gold, for example, should benefit in an environment of runaway inflation. Nevertheless, active, alternative strategies that are aligned with accentuating trends or higher volatilities on the interest-rate, currency and commodity markets also offer the opportunity to diversify an equity-heavy portfolio. In the illiquid domain, it is mainly infrastructure and agricultural investments which offer a certain degree of protection against inflation. But ultimately innovation is still in demand. For those wishing to make a long-term commitment to new, key technologies, specialised venture and private equity investments are one way to go. We would be happy to advise you in a personal meeting.

Patrick Erne
Head of Research

TOP IDEAS FOR 2022

Here is a selection of the tactical investment ideas for 2022 with particularly attractive risk/return profiles per asset class:

Fixed-income investments
- Chinese bonds: unlike the US and Europe, China has experienced some softening in the economy and the real estate market is under strain. We are therefore expecting more stimulus measures here, and yields should generally fall in contrast to the West, lifting bond prices.

Equities
- European small caps: we are expecting positive economic momentum in Europe in 2022. Smaller capitalised companies should be some of the biggest beneficiaries.
- Value shares: with the economic outlook positive, we see potential in cyclical stocks which have not yet fully reflected the recovery and should therefore outperform the overall market in an environment of elevated inflation. Examples are energy, banking, travel and selected emerging markets such as Russia.
- Healthcare shares: shares from the healthcare sector offer the right mix of structural growth in demand, recurring cash flows and high profitability. Defensive large cap pharma stocks (e.g. Roche, Novartis and Sanofi) are also attractively valued.

Liquid alternative investments
- Active strategies that benefit from different price trends in equities (e.g. value vs growth, winners of regulation vs losers) and exploit market fluctuations with active management.
- Systematic and fundamental strategies that can position themselves on accentuating trends (including negative ones) in the interest-rate, commodity, stock and currency markets.

Illiquid real assets
- Infrastructure assets which make an important contribution to the energy transition and climate protection offer attractive recurring cash flows and direct ownership of real assets.

Healthcare shares

Investing for every environment

The pandemic has shown how important health is for all of us. On the positive side, the healthcare sector is currently undergoing a remarkable surge in innovation. Besides the increasing digitalisation in the health sector, research is being conducted on a plethora of new approaches to treatments and technologies. Vaccines based on mRNA technology are an example of how effectively and quickly new areas of application can be opened up as a result. The megatrend of "the ageing society" is resulting in the steady growth of demand in this area. So shares from the healthcare sector are attractive as long-term investments.

Quality stocks with good growth

Numerous companies meet important quality criteria, especially in the healthcare sector. High barriers to entry, ever higher recurring cash flows and solid profitability are just a few. Their specific areas of activity are may vary widely, but they offer clear growth in future years. There are many companies to choose from, especially in medical technology and diagnostics. Admittedly, the valuations of many of these companies are high. But thanks to strong growth, it is possible to ride out temporary falls in prices or exploit them to add to positions.

Dividend shares currently offer good value

Large-cap pharmaceutical companies have been lagging the overall market for quite a few years now. For 2022, we see catch-up potential especially in this particular segment. Besides above-average dividend yields, there are other reasons to be overweight.

1. The risk of regulations resulting in price reductions has fallen (at least temporarily). In the important US market, the Democrats are focusing their efforts on infrastructure programmes and other support stimuli. Regulating prices for medicines has come off the priority list. It also remains to be seen whether the Democrats will be able to hold onto their majority in the House of Representatives in the mid-term elections.
2. Within the defensive sectors (pharma, telecom, consumer staples and utilities), we prefer pharmaceutical companies. Their sales are largely unmoved by economic fluctuations, margins are not very vulnerable to rising commodity prices and balance sheets are largely solid. They are also resistant to rising interest rates.
3. Valuations are attractive in both absolute and relative terms.

Innovation and growth

Innovation is in demand. The future belongs to companies which can differentiate themselves here. In the biotech sector, countless people are researching new technologies and active substances. But the road to commercial approval is long, needs funding and many companies fail along the way. Those that clear these hurdles usually see their value soar or are bought out by the big pharmaceutical companies for a high premium. Knowing where the next breakthrough will come is hard to predict. Therefore, we only invest in this area in a diversified manner using fund vehicles from selected specialists and do not focus on individual stocks. For risk-tolerant, long-term investors, there is the option of investing in specialised venture capital funds.

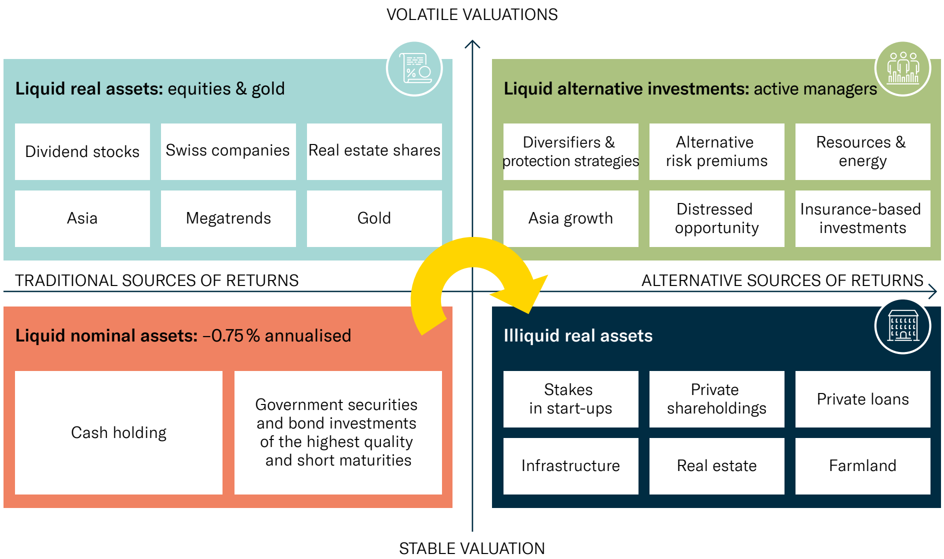
Matthias Ramser
Chief Investment Officer

	Medical technology/life sciences	Large-cap pharma	Biotech/venture
+	◆ High entry barriers ◆ Dominant market position in a growing market ◆ Big margins and solid profitability	◆ Diversified product portfolio ◆ Attractive valuations ◆ Stable cash flows and dividends ◆ Defensive component for the portfolio	◆ Acquisition of companies for high premiums ◆ Blockbuster development
–	◆ Valuation risks due to high expectations ◆ Product lawsuits	◆ Pricing pressure due to regulations ◆ Patent expiry risks	◆ Negative cash flows and dependence on external capital ◆ High failure rate
Our favourites:	ThermoFisher, Lonza, Straumann	Roche, Novartis, Sanofi	Selected funds

Generation portfolio

When inflation comes knocking and volatility becomes a concern

Many of our clients think long-term: over several years, often decades and sometimes even generations. But they often shy away from temporary volatility even with investment capital that isn't used to fund living costs. As a result, nominal assets such as cash and bonds make up a substantial part of the investment strategy.



Historically, this has worked well. That is because sharply declining interest rates over the past decades have delivered bondholders handsome profits with low volatility, and thanks to structural forces such as demographics, debt and digitalisation, while inflation has remained at historically low levels.

But looking to the future, it's clear that things will be rather difficult from now on. Investors should not let themselves be driven by daily events, and need to recognise the "big turning points", which is especially true if they think in terms of generations. Nominal interest rates have been close to zero or even negative for some time. Cash in instant access accounts is simply being eaten up by fees and capital gains on bonds are not an option. All this in an environment with globally rising inflation rates. It will no longer be possible to maintain the purchasing power of money using nominal value investments. If the market is to be believed, we would expect to see a loss of purchasing power of around 20% with bonds in Germany over the next 10 years. In the UK, that figure could be even be as high as 30%.

Investors thinking on a generational scale should therefore reduce the weighting of nominal value investments in the investment strategy down to the level they need to live on for the next few years. Pre-fund planable spending in nominal value money using nominal value investments – and leave it at that.

We see better prospects for preserving value in "liquid real assets" such as equities. Time and time again, cash flow-strong quality stocks with good management teams have been shown to be particularly good at creating shareholder value even in an adverse market environment. These investments will help maintain purchasing power, but do come with volatility.

Not all investors have the same high tolerance for jumpy prices. Adding in "liquid alternative investments" can help here, as they open up other sources of returns and, even more importantly, diversify a portfolio, i.e. stabilise it. Often very specific expertise is required and therefore an "open architecture" is recommended when putting this into practice.

There are also targeted opportunities in the area of "illiquid real assets". This capital is tied up for a longer period and investments such as in infrastructure, private equity and farming facilities provide opportunities. That is why a cautious, step-by-step approach makes sense.

We support our clients in developing and implementing a "generation portfolio" in the individual segments as well as in the overall coordination. The liquid building blocks can be quickly and agilely adjusted, while including personal preferences is key for illiquid real assets. Interested? We look forward to discussing how your very own personal generation portfolio can be built up step by step.

Silvan Betschart
Research,
Head of Investment Policy

“Mutual trust and continuity”

A conversation with Tobias Pfrunder

2021 was a good year for investing – are you pleased?
Definitely! We’ve really had to roll our sleeves up over the last few months and had very little time to catch our breath. We’re delighted to have such loyal and trusting clients, and to have seen a steady increase in their numbers. Our extensive network, made up of clients and business partners, has recommended us to their families, friends and acquaintances. This shows how much they appreciate what we do every day.

You’ve got many years of experience under your belt. How has your job changed?
When I joined Reichmuth & Co 20 years ago, we were a young company. As a relatively new banking institution, we had to adapt and optimise our processes to the new regulations, the changing framework conditions and other developments. One was the move to become a paperless office based on the “straight-through processing” approach. Nowadays, it’s about digitalising operations and new developments that offer clients a digital experience in meetings and exchanges. Our advisory services per se haven’t changed significantly. At the core, it’s still about the needs of the clients, just as it always has been. As the range of investment opportunities has multiplied over the years, so has the complexity. The importance of holistic advice has increased. To know our clients’ goals and meet their expectations, we need to listen to them and understand how they think. That’s why we’ve never been product sellers. We strive to find a tailor-made investment strategy and a way of implementing it for each client that suits him or her. This calls for a lot of mutual trust and continuity in the relationship.

What do you particularly enjoy about your job?
After all these years, I’m privileged to have so many interesting, admirable and fantastic clients around me every day, many of whom have even become personal friends. Together with the dynamic, ambitious but always human Reichmuth & Co team, my work has become my passion. With our tax-optimised occupational pension solutions, far-sighted pension planning and unique investment opportunities such as infrastructure, it’s a great pleasure to offer something that creates real added value for our clients.

Where do you see the biggest challenges ahead?
I’m expecting an inflationary environment over the next few years and a trend towards higher interest rates than today. This will lead to higher volatility in portfolios and I’m keen to prepare my clients for this. Both the willingness and the ability to take risks will be crucial. In meetings with my clients, I try to highlight the risks in the strategy and the investments, partly with the help of scenario analysis.

> **“The importance of holistic advice has increased.”**

What advice do you give to your clients?
An integral, holistic view is the key. It’s the only way to assess risks correctly and optimise costs, taxes and income. It lays the foundations for appropriately aligning the assets as a whole and being able to make informed decisions quickly in the event of turbulence. It helps to have a concrete plan that you can use to periodically assess the situation. This is exactly what we need to do now with our clients in view of the possible challenges facing us in 2022 – I’m looking forward to having these conversations.