# CHECK-UP

September 2022
Client information
Reichmuth & Co Private Bankers



## Editorial

The world has fundementally changed in 2022 and this is the focus of this check-up.

What should investors' response be? With trouble and turmoil all over the world, should they retreat into their "redoubt" and only invest in the domestic market, hoarding their cash or gold in the bunker? Or is a global "diaspora" strategy the right response, where you spread your assets across the different regions of the world? Upheavals always offer opportunities – where do we see them today?

A black-and-white answer is probably just as wrong as a general one. The appropriate solution to these questions must be found in a personal meeting and will depend on each individual. We wish you a stimulating read and look forward to having a discussion with you.

**Remy Reichmuth**
General Partner


**The World turned upside down. Households, companies and investors are groaning under the weight of high inflation, war is being waged in Europe, and sabres are being rattled in Asia. The dream of lasting peace, a globalised economy in a democratic world, and a cost-free energy transition has been shattered.**

Confusion and disorientation – collectively this is known as "delirium". It's no wonder, then, that the current uncertainty and rising interest rates have led to sharp corrections in prices. It's a time in which everyone is feeling uneasy – there are simply too many shifting pieces of the puzzle. The following trends are emerging:

**1. Geopolitics taking a leading role**
China and the USA form the two extreme poles of current geopolitics. This is problematic for the world economy and even more so for the global problem of climate change, as

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the latter can only be tackled jointly. Western democracies are rallying behind the USA. And although hardly anyone is rallying behind China, some countries fear ruining their chances with the rising global power and its gigantic economic zones. At this point, no one knows whether the Taiwan issue will be resolved over time similar to how Hong Kong was handled or whether a military conflict will ensue. What is clear is that the Russian invasion of Ukraine and the subsequent sanctions imposed by the West will result in the creation of a new global economic system. But what it will look like is still an open question.

**2. End of unconventional monetary policy**
"Unconventional monetary policy" was always a troublesome combination of words. The proponents of "Modern Monetary Theory" (MMT) have also fallen silent, as it states that governments can always spend money and take on more debt until inflation brings it all to a halt. Well, inflation is certainly here. But the fact that the state should now be spending less has not yet dawned on many governments, leaving central banks to fight inflation on their own. While the US Fed seems to mean business, the European Central Bank is waving its magic wand around and looking for more rabbits to pull from its hat. Sooner or later, it will have to decide between fighting inflation, which will plunge the eurozone into a new survival crisis, or placing a higher priority on eurozone cohesion, which would cause the euro to have a fate similar to the Italian lira's. And what is the Swiss National Bank doing? We are in the middle of Europe, after all. Its options will be limited to letting the CHF appreciate via interest rate hikes and/or balance sheet reductions to the same extent as high foreign inflation.

**3. Fiscal policy stance**
For many years, governments were able to live beyond their means and fund virtually any programme with new debt. The central banks' unconventional monetary policy masked the financial crisis in 2008, the euro crisis in 2012, and finally the coronavirus crisis in 2020 – always under the guise of combating the threat of deflation. The wind has now changed and has a sharp edge to it. This means the end of the state's land of milk and honey, as they are being forced back into the corset of budget restrictions and will have to choose what they want to spend money on: education, security, energy, infrastructure, the environment or social transfers. They will also have to ask themselves how they can fund it – through taxes or more debt once again? And if it is the latter, who will buy these government bonds and at what interest rate given the high inflation? Central banks will probably not be buying anything for quite some time.

**4. Energy transition in jeopardy**
Decarbonising the economy is one of the great challenges of our time, and Europe wants to lead the way. Gas-fired power plants were originally intended as a backup for slack periods (no sun or wind). However, the Russian invasion of Ukraine has ended the era of peace in Europe. The sanctions imposed under US leadership have turned the planned energy transition into an energy crisis. Energy import policy lies in ruins, with no exit – and therefore no lower energy prices – in sight. And Germany is at the centre of the storm. It's not just about the price; the question now is whether there will be any energy available at all. The measures taken so far with subsidies and rationing are merely treating the symptoms. Investment-friendly, i.e. supply-oriented, reforms are what is really necessary, along with more openness to technology. But what is needed above all is the certainty that the key players will not be robbed of the fruits of their labour through the levying of one-off taxes.

**What would happen if…**
**…the gas flow is actually cut off?** It would be an enormous problem for Europe, causing a shock, an inflationary depression, and financial markets to collapse again: probability of 20%.
**…the war in Ukraine and the sanctions came to an end?** It would be an immense relief, especially for Europe, and bring a potential wave of optimism with it. Financial markets would rise sharply: probability of 20%.
**…things continue as they have been since the beginning of the year?** The world will keep rallying around the two geopolitical poles, inflation will likely remain persistent, and a kind of re-run of the 1970s will take place with a wage-price spiral, as is already being observed in the US. Inflation rates will enter an "up-and-down" period, which will be countered by corresponding "stop-and-go" policies by central banks and governments: probability of 60%.

**Inflation too high for too long**
Due to the increased uncertainty, valuations will generally be lower, and so recommendations similar to those in the 1970s make the most sense, i.e. few long-term nominal investments and a focus on shares in companies with less price-sensitive business models, especially high dividend-yielding stocks. Cash in hard currencies – DEM and CHF at the time – was also a positive strategy. And still is today! Gold, possibly, and the CHF, at least in relative terms.

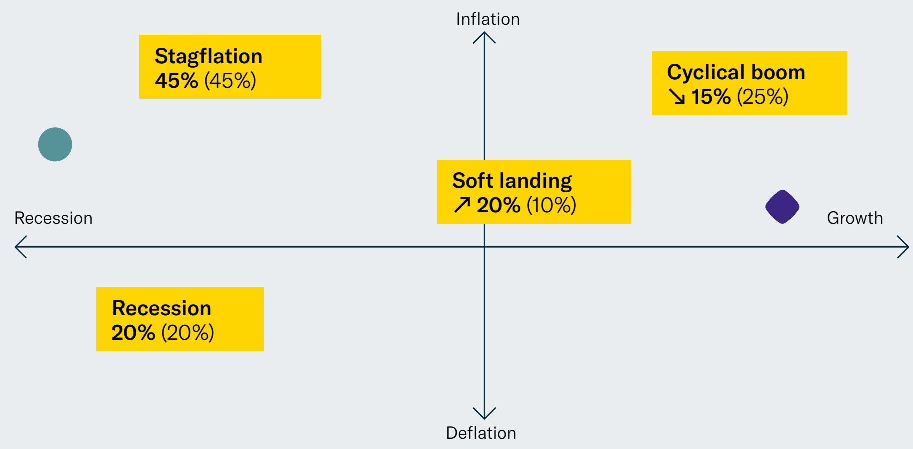
**Christof Reichmuth**
General Partner

# Our scenarios

## Focus on two bipolar options

The geopolitical environment is more fragile than it has been for a long time, making the scenarios more dynamic and distinctly different from region to region. Specific events can have a major impact on financial markets.

**Let's focus on two bipolar developments – and what the investment consequences would be.**




Scenarios    Estimated probability of occurrence, amount from last publication shown in brackets

### Restructuring costs of the transition to a new era

While the Fed strives to tighten financial conditions and cool the real economy to keep long-term inflation expectations in check, ECB policy can at best be viewed as "interest-rate cosmetics". The ECB cannot raise interest rates drastically because this would cause the EUR periphery countries with their high debt levels to fall into an inescapable crisis. Putin pushes the successful German economic model to its limits by completely turning off Russian gas supplies. In the face of collective political failure, Europe cannot persuade the warring parties to declare a ceasefire, which is considered a basic prerequisite for alleviating the energy crisis. Europe lurches into an economic depression with stubbornly high inflation in the core European countries. The energy supply shock cannot be solved by the central bank; true statesmanship would be required here.

**Portfolio effects:**

- Fixed-income investments in Europe are uninvestable – inflation and currency losses
- Few equities in general – avoid European stocks in particular (domestic market)
- Defensive sectors such as consumer staples and healthcare
- Broad diversification with alternative investments
- Head for safe currency havens (USD, CHF and SGD)
- Further increase gold as a crisis and inflation hedge

### The clouds "lift"

The pandemic has derailed global supply chains, while simultaneously, a great deal of demand has built up. There are signs of easing on both sides of the economic equation and, coupled with the end of China's zero-COVID policy, inflation rates around the world normalise rapidly. The decline in inflation in Europe is fostered by a ceasefire between Ukraine and Russia. The issue of energy security in Europe can be solved, which also prevents a protracted and painful wage-price spiral. Companies' margin pressures ease and profit estimates can be achieved or even exceeded, enabling central banks to put an early end to the cycle of interest rate hikes. The structural upward trend in assets continues.

**Portfolio effects:**

- Prefer credit investments such as high-yield bonds to government bonds
- Increase equities – quality and growth stocks in particular recover quickly from corrections, but cyclicals and small caps also benefit
- Emerging markets – both bonds and equities show attractive upside potential
- Reduce USD

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Cajetan Bilgischer and Silvan Betschart

# Bear market rally?

## Weaker economy and persistent inflation

**Inflation figures appear to have reached their peak, at least if one considers the market development over the last few weeks: interest rate expectations are declining and stock markets are on a strong rebound. The underlying picture has not changed, however. Central banks continue to pursue a restrictive course, the economy is cooling, wage and margin pressure is building, and the geopolitical situation remains unpredictable. In our view, it is still too early for a significant increase in risk allocation.**

### Economic winter in Europe

The global economy has weakened over the past months. Leading indicators are not pointing to a turnaround – with growth likely to slow further, especially in Europe. The severity of the slowdown will depend on various factors: In Europe's case, access to Russian gas will be crucial. If Europe runs out of gas (and electricity), a far-reaching recession looms – and the Swiss economy would not escape unscathed either. The US is significantly better positioned in terms of energy and is not dependent on foreign imports. The biggest risk it faces instead is monetary policy. If, in order to combat inflation, the Fed is forced to raise interest rates more than generally expected, this could push the economy into a deep recession in the next two years. Out of the three major economic areas, the USA is in the best shape. China's economy has been in a slump for several quarters already. Its zero-COVID policy is proving a growth killer, and problems in the real estate market are also hampering growth. The Taiwan conflict remains impossible to call – a quick solution is not foreseeable since Taiwan is too important for both sides as a chips producer.

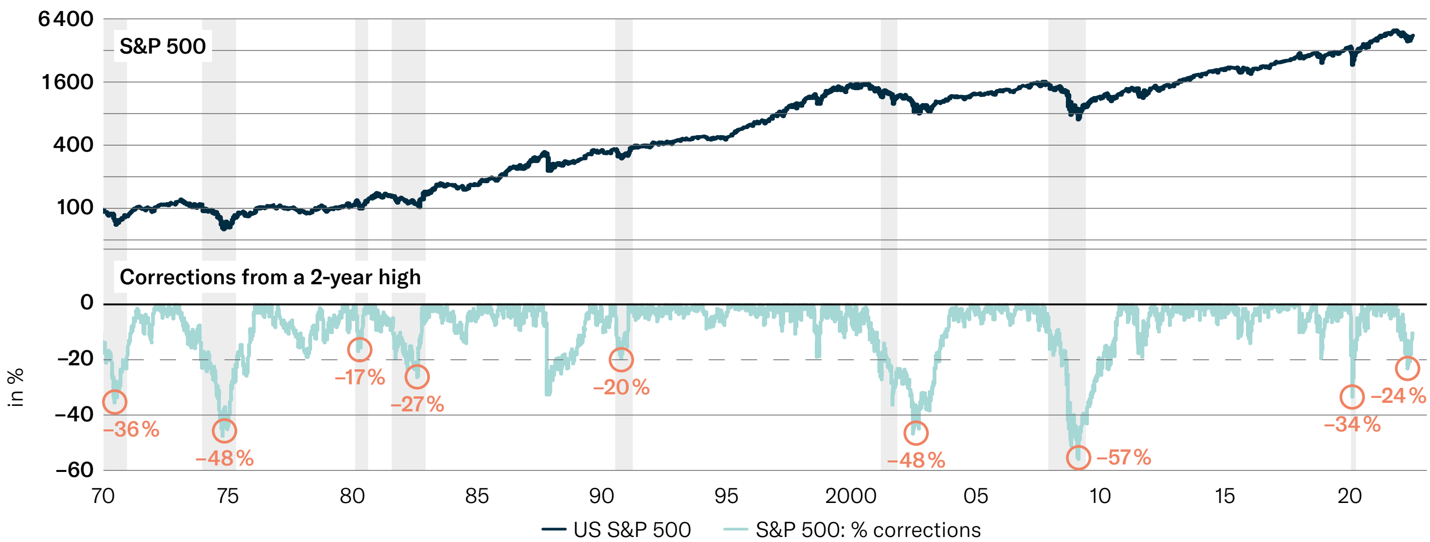
### End of USD dominance?

Monetary policy has become more restrictive throughout the West, and key interest rates are rising across the board. Although all of the central banks are lagging behind inflation in the rate hike cycle, countries such as the USA and Australia are already much further along in the hike cycle. This is also reflected in exchange rates. Whereas the USD has been strong over the first eight months of the year, central bank currencies with a more hesitant stance are under pressure (e.g. the EUR). However, as the interest rate differential between individual currency areas cannot widen arbitrarily, we anticipate the strong USD will weaken. Currency areas with lower inflation figures are likely to be preferred, in particular the CHF.

### Persistent inflation

Inflation remains very high. Labour markets in the USA have shown no signs of weakening, and wages are also climbing. In spite of this, the market still expects inflation to normalise very quickly, enabling central banks to lower interest rates again. A slowdown due to base effects and some easing in energy prices is realistic, but we consider a normalisation of inflation to pre-COVID levels within the next two years unlikely. Rents, which are highly weighted in

STOCK MARKET CORRECTIONS OF OVER 20% USUALLY HAPPEN DURING A RECESSION




Grey areas are recessionary periods – Source: Bloomberg (Status: 24.08.2022) the inflation basket, are rising. Heatwaves and drought in much of the world mean food inflation remains elevated, and higher wages are being offloaded onto prices wherever possible. It is therefore becoming increasingly unlikely that central banks will cut interest rates again in the foreseeable future.

**Credit risks vs interest rate risks**

We consider it premature to increase the duration in your portfolios, although bonds have become somewhat more attractive thanks to rising returns. Not only have yields gone up, credit spreads have also bounced back from the lows of 2021 to the long-term average. This means that high-yield bonds in the USD currency area are yielding around 7.5%, making them an alternative to equities, whose earnings estimates still seem quite high, given the weakening economy. We currently prefer credit risks to interest rate risks.

**Europe and China at a discount**

We remain underweight in equities. In our opinion, a significant increase in equity exposure is only advisable when an end is in sight to key interest rate hikes (USA), energy prices correct significantly (Europe), the USD weakens (emerging markets), or valuations undershoot in general. The latter would be the case in China and in Europe, but given the geopolitical challenges, no one is very confident at the moment, and so we prefer to wait. As winter approaches, the pressure will likely increase on European politicians to push for a ceasefire in Ukraine. However, since such a move would inevitably cause a loss of face, a clear political majority is anything but certain, which is why we remain underweight in Europe.

**Recovery rally in a bear market**

In addition to energy stocks (see page 7), we continue to lean towards healthcare at a sector level. The majority of the large pharma companies have come out of the correction in good shape thanks to their defensive nature. Given the correction in the first half of the year, valuations of quality and growth companies (including outside of healthcare) also seem more reasonable to us. If inflation figures ease slightly, the current recovery should last for a while longer. In the cyclical sector, small caps in particular have corrected sharply. Although rising costs are a major challenge, some segments have nevertheless been excessively punished. For investors who want to get involved in this segment in the long term, the current levels offer some initial buying opportunities. But overall we view the current recovery rally on the markets as a reversal in a bear market that is still ongoing, and we are holding firm with our defensive stance.

**Patrick Erne**
Head of Research

BRIEFLY NOTED

# How can you diversify?

Both equities and investments corrected similarly in the first half of 2022. Until the middle of the year, a 50% equity / 50% bond portfolio traded similarly to a 100% equity portfolio. So where can diversification still be found today? Here are three concrete options that are often overlooked by many investors:

1. **Add alternative investments:**
   In the first half of 2022, active strategies such as macro and trend-following strategies were the only ones to achieve positive performance contributions, profiting from rising interest rates and commodities, among other things. We still regard additions as an attractive option.
2. **Illiquid investments**
   Daily valuations are usually not available for illiquid investments, so they often stabilise an investment portfolio. Infrastructure and farmland are two attractive categories in which the current environment offers interesting solutions.
3. **Integral planning:**
   This is essential if a loss on an investment has to be absorbed because money is needed, or if a bear market has to be sat out. Options for action should therefore always be included – which also helps to take advantage of tax benefits.

We would be happy to meet with you personally to discuss these and other opportunities to diversify and strengthen your resistance to crises as well. Feel free to give us a call..

# Energy – the topic of the decade

## From the “Green Deal” vision to securing energy supplies

**Europe wanted to become the first climate-neutral continent and achieve net-zero greenhouse emissions by 2050. The boot is now on the other foot, with energy security the dominant issue and likely to preoccupy politics and society for years to come.**

### Index weighting?

The demand for energy is growing, particularly in emerging economies. In the short to medium term, the focus is on access to fossil resources such as oil and gas; in the medium to longer term, it shifts to the expansion of renewable energies. This makes it all the more astonishing to see how much weight energy companies carry in the world stock market index today. A mere 4%, which is in sharp contrast to the technology sector with its current weighting of 22%. In retrospect, there were certain arguments that justified such a low weighting. Russia was considered by many to be a reliable energy supplier, investments were channelled primarily into other areas with higher growth rates, and as climate awareness increased, many institutional investors banished fossil fuel companies from their portfolios. As an active and forward-looking investor, the current low weighting for the next few years does not appear logical.

### Direct equity investments

In addition to favourable valuations, we view the high regular distributions (dividends and share buyback programs) as one of the arguments in favour of listed energy companies, whose cash flows seem secure for the next few years since the supply can hardly be expanded at all. Alternatives such as nuclear energy are not (yet) politically acceptable, and other promising technologies lack the necessary maturity. In the medium to longer term, the major energy firms are also likely to emerge as dominant players in the renewable sector. Until then, we also recommend targeted investments in renewable energies. Suppliers are benefiting from full order books. Companies specialising in energy efficiency are likely to be in demand as well (e.g. building services engineering, heat pumps, climate control, etc.).

### Financing the infrastructure

For long-term investors, we recommend an allocation of specialised infrastructure assets. Expanding and modernising infrastructure in the energy sector requires tremendous amounts of money that hardly any state can fund alone – making them dependent on external investors. In return, investors receive a long-term, contractually secured fee, which in many cases is also adjusted for inflation.

### Regional and individual preferences

Access to energy is becoming more and more of a competitive factor. Europe will be at a clear disadvantage on this front over the next few years, and its high energy dependency could become a geographical disadvantage. Energy security will now become an important factor for regional asset allocation as well, and play a role extending beyond stock selection. Personal sustainability preferences are of special importance for investments in the energy sector, as you can set clear priorities when selecting stocks. We are happy to customise our best investment ideas in the energy sector to meet your individual needs.

**Silvan Betschart**
Research,
Head of Investment Policy

### Opportunities alongside the value chain

| | Critical raw materials | Energy efficiency and storage | Alternative energies | Oil producers | Infrastructure assets |
|---|---|---|---|---|---|
| Why | Structural tailwinds after years of underinvestment | Critical components, e.g. energy control, compressors and cables | Central to the energy transition and with great growth potential | Supply cannot be expanded in the short term | Attractive, private investments in transport, district heating and wind/hydro power |
| Opportunities | Capacity bottlenecks drive up prices | Attractive niches with structural growth | High growth and politically supported; good $CO_2$ footprint | High current distributions and a favourable valuation | Real assets with political tailwind & inflation protection |
| Risks | Partly cyclically sensitive or in politically unstable countries | Often expensively valued or not found in pure form | Reliability (slack periods); Scalability | Potential additional taxes; energy transition and low oil prices | Interest rate sensitivity |

# Inflation moves the interest rate needle

## What does that mean for you in particular?

**In June, the Swiss National Bank raised its key interest rate for the first time in 15 years, and negative interest rates will soon be a thing of the past, so it's worth taking a look at different interest rate scenarios and their effects.**

**Where will interest rates end up?**
Compared historically, we are at very low interest rate levels, both for the key rate and the 10-year interest rate. The real comparison is even more striking when interest rates are adjusted for inflation. Real value preservation is a long way off for nominal value investors.

| | CHF | EUR (DE) | USD |
|---|---:|---:|---:|
| Key interest rate | –0.25% | 0.5% | 2.5% |
| 10-year interest rate | 0.43% | 0.93% | 2.8% |
| ⌀ over last 50 years | 1.9% | 3.7% | 6.1% |
| Inflation | 3.4% | 7.5% | 8.5% |
| Real returns | –3.65% | –7% | –6% |

Even if some of the current inflation is transitory in nature, many indicators suggest that inflation will remain at an above-average level over the next few years. If inflation in Switzerland settles at 2%, for example, long-term interest rates of 3–4% would be expected from a historical perspective. If we assume a positive real interest rate of 1–2% as fair compensation for the inflation and maturity risks, then key interest rates would probably settle slightly below this in the 2–3% range.

**How do higher interest rates affect valuations?**
Interest rates play a central role in the valuation of financial assets. The discount rate is used to discount future cash flows of all types of investments, thus determining the "fair" accounting value. The lower the discount rate, the higher the discounted future cash flows and consequently the current valuation – and vice versa. However, the discount rate is often based on various factors, such as the structure of the financing side and/or maturities, etc.

**What do higher interest rates mean for real estate investments?**
Among other things, real estate investors were able to enjoy appreciation gains over a long period due to falling discount rates, and real estate funds often traded at premiums compared to intrinsic value. These premiums have now corrected due to the turnaround in interest rates. In contrast, the discount rates for valuations at real estate companies have still barely moved. A sensitivity analysis of a Swiss company shows: The average discount rate as of mid-2022 was 3.6%, and an increase of +0.4% would negatively impact the fair value of properties by at least –12%. A look back shows that the rate has been higher before, e.g. it was just under 5% at the end of 2010. This makes it all the more important to examine real estate companies' respective financing structures and determine which current debts can be refinanced at lower rates – resulting in positive effects as well.

**Is now the time to lock in mortgages for the longer term?**
Interest costs of around 2% can currently be expected for a 10-year mortgage in Switzerland, whereas rates for a variable mortgage are 0.8%. We start by assuming a "fair" 10-year interest rate of 3% (currently 0.5%) and expect key interest rates of 2%. In this scenario, a mortgage would become more expensive at 4.5% over 10 years, or reach 2.8% for variable mortgages. Based on a mortgage of CHF 1 million, this would result in around CHF 20'000–25'000 of additional interest costs per year. The central question, therefore, is one of affordability and risk capacity. If the potential additional interest costs are not an issue, then a variable mortgage usually makes more sense. However, anyone who might struggle to bear such additional interest costs should opt for a fixed rate. In the short term, this will entail extra additional costs compared with the variable rate, but reduces the overall risk of financing.

**What should you do?**
A wide variety of factors determines how high interest rates will rise, making it vital to prepare for possible scenarios and assess the relevant effects on your personal financial planning. In many cases, alternative financing solutions can also increase your options for action. We would be happy to assist you in this area.

**Tobias Pfrunder**
Clients, partners

# Calm, careful – with an eye on opportunities

Interview with Dr Matthias Ramser, CIO

**This year has been a very challenging one so far for investors. What was particularly unusual?**
Pandemic-related supply bottlenecks coupled with pent-up demand caused the price of goods to rise as early as the beginning of the year. As the consequences of the war in Ukraine began to be felt, central banks had to admit that inflationary pressures would remain more persistent than had long been expected. The central banks' interest rate hikes then led to a sharp correction on stock markets. Of course, price declines of 15–20% are not unusual per se; we see them on average every two to three years. But what was certainly unusual was that, as interest rates rose, high-quality bonds also plunged in value, dragging portfolios with high bond holdings well into the red. Over the last 20 years, bonds have had excellent diversification qualities, but as we expected, this characteristic has now disappeared.

**In Switzerland, the era of negative interest rates, which has lasted since 2015, is coming to an end, while interest rates have already risen globally. Are bond purchases starting to make sense again?**
When buying bonds, you always have to consider what you will have left after deducting inflation and whether purchasing power can be maintained. We recommend holding bonds in currencies such as the CHF, where inflationary pressures are lower. With high-yield corporate bonds, we see selective opportunities with rising risk premiums, and we are gradually building up positions. In general, however, we continue to recommend adding diversification and inflation protection to your portfolio by means of alternative investments. This strategy has already been useful during a difficult 2022.

**So your outlook for equities remains cautious?**
The MSCI World Index had lost about 20% by mid-June. Share prices have subsequently recovered, as the US economy in particular is proving to be more robust at the moment than expected, and the half-year results were well received by the market. Nevertheless, we believe it is still premature right now to speak of an end to the bear market. It remains to be seen whether central banks will succeed in fighting inflation without triggering a steep recession.

**How are your clients reacting to the greater turbulence?**
Like investors on the stock markets in general they have been reacting calmly and carefully in 2022, in my opinion. The crises of the last few years have hardened them. Many are focusing on the long-term picture and know this comes with short-term volatility In a recent meeting with a client, I discussed a possible "redoubt strategy". She was considering holding only defensive, domestically oriented quality stocks from Switzerland. But then she decided against it – it's also dangerous to focus exclusively on the risks and ignore the opportunities that present themselves. As they do exist.

**Can you give us an example?**
The topic of energy, as mentioned on page 6. I'm also again seeing more attractive valuations in the growth segment and in some Swiss second-line stocks which were very badly punished. Personally, I have bought biotechnology stocks in recent weeks, which offer appealing access to growth and innovation.

## Schedule for 3rd trimester

**"2023 Market Outlook"**
Our traditional private client events

| | | |
|---|---|---|
| **Lucerne:** | 7 Nov., | 5:30 pm |
| | 21 Nov., | 6:30 pm |
| **St. Gallen:** | 17 Nov., | 6:30 pm |
| **Zug:** | 9 Nov., | 6:30 pm |
| **Zurich:** | 10 Nov., | 5:30 pm |
| | 15 Nov., | 6:30 pm |
| **Munich (DE):** | 23 Nov., | 7:00 pm |
| **Essen (DE):** | 28 Nov., | 6:30 pm |

You will receive the invitations at the beginning of October.