CHECK-UP

January 2023
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Reichmuth & Co Private Bankers

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Editorial

As we enter a new year, we would like to wish you the very best and a 2023 filled with happiness and good health.

The past year has been an eventful one that was embossed by geo-political upheavals. The impact on various aspects of life has been far-reaching. Long-term trends such as globalisation, low interest rates and deflation have gone into reverse.

Something new is emerging. And this means new investment opportunities and attractive risk/return expectations. In keeping with our motto of "People and money in harmony", a personal investment strategy needs to be aligned with the new environment. "They must often change, who would be constant in happiness" (Confucius).

This Check-Up should serve as a navigation aid for you. Thank you for placing your trust in us, especially during what has been a challenging past year. We look forward to personal discussions with you in the near future.

Remy Reichmuth
General Partner

Major recalibration

All in all, 2022 was a choppy financial year. Securities markets always respond quickly to new developments, but often overdo it. The Russian invasion of Ukraine and subsequent sanctions imposed by the West resulted in shortages of energy and raw materials. If demand remains unchanged, prices will explode, so the only way of alleviating these types of supply shocks is to reduce demand, experience a recession, or increase supply.

Governments showering consumers with cash may ease their pain, but it will not have a lasting impact. The events of 2022 have put the economy out of kilter, and adjustments are now taking place at all levels in the ongoing search for a new equilibrium.

Geopolitical imbalances

The rivalry between the USA and China, Russia's decoupling from Europe, and the surprisingly united West and its sanctions mean a new

assessment of the situation is needed. Germany's success model – outsourcing security to the USA, sourcing raw materials and energy from Russia, and exporting to China – lies in tatters, as does its ideologically driven energy transition. High energy prices have put Europe, and Germany in particular, at an immense competitive disadvantage. The only remaining hope is that these crises will unleash creative energies and shake Europe out of its complacency, forcing it to assume a leading role powered by technology and engineering over the coming years. That would be a blessing for the process of decarbonisation.

Fragmentation of the global economy
Gone are the days when advancing globalisation made the world smaller and production processes more efficient. Large parts of the world's population have experienced huge leaps in prosperity, but it is now becoming evident that globalisation has gone into reverse, with geopolitics taking centre stage. This is having consequences for the global economy: free trade and high levels of legal security are giving way to geopolitical deliberations backed by pressure and sanctions. Politics rarely has a long-term effect on stock markets, but today's developments are far-reaching, meaning that patience is required as governments, companies and people need time to adapt to this new world order.

Fiscal and monetary policy on a confrontational course
While Western nations stuck with their high-spending programmes, central banks woke up and slammed on the brakes in the second half of the year. If you push the accelerator and brake pedal down at the same time, however, the ride can get pretty bumpy, which is what happened in the UK. While the Bank of England was pursuing a restrictive course, the short-lived prime minister Liz Truss launched an expansionary fiscal programme. Financial markets immediately responded with a fall in the value of the British pound and a rise in yields on government bonds, giving the pension fund system a nasty shock. The Bank of England, realising it had to ensure financial market stability, relented and stabilised long-term yields with bond purchases. If the rapid interest rate hikes in the US or even the rather lethargic series of interest rate bump-ups in Europe lead to similar problems, then financial market stability will clearly trump monetary stability! As a result, we are expecting a decade of elevated inflation. Of course, inflation will decrease in 2023 due to the base effects. To ensure we are not distracted by these effects, we are focusing on core inflation and inflation expectations.

Financial markets in an adjustment process
In the USA, the risk-free rate of return is 4.5%, which is already about 2% higher than the expected average inflation rate of 2.3% for the next 10 years, making the money market quite attractive. Ten-year rates are around 3.5%, but this would only interest us if there were a deep recession by mid-2023, as we suspect that current inflation expectations in the market are too low. That is why the bond markets, like the equity markets, are still searching for a new valuation level and remain very volatile. After the correction in 2022, many of the overvaluations in equities have disappeared. What happens now will largely depend on the inflation trend. Less liquid markets, i.e. those in which prices are calculated with models or valued on the basis of a few transactions like real estate, have not yet reached the new valuation levels.

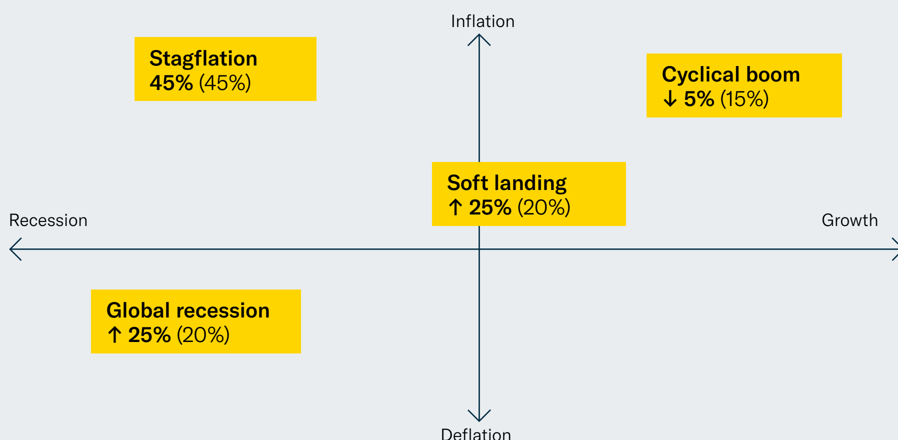
Currencies as an outlet
Currencies represent a type of accumulation of a country's uncovered cheques, which is reflected in the exchange rates. Since the US and Europe have many such uncovered cheques (due to trade deficits, among other things), both should tend to weaken against the CHF. Switzerland still has trade surpluses, and the population is in favour of the central bank's stability-focused monetary policy.

More diverse options for investment strategies
Calibrating the portfolios to match this new environment actually means a more diverse menu can be offered once again. The limited fare of the past 10 years is a thing of the past. This will have an impact on the expected future returns. Interest is now being paid again on both the money market and bonds. Increased credit risk premiums are making the high-yield USD segment look attractive. Equities are generally no longer overpriced, except perhaps in the USA. China and Europe are attractively valued, although this is still due to commonly known reasons. However, China is at risk of being hit with sanctions because of the Taiwan issue. In Europe, a buy signal is likely to come only at the end of the energy crisis. In general, dividend stocks remain attractive in this environment of increased inflation, as do cash-flow generating infrastructure assets.

Christof Reichmuth
General Partner

Scenarios and investment consequences

Winter season as a harbinger for the global economy



Current assessment

- Stagflation regime dominates and further slowdown in economic growth
- Peak of the current interest rate cycle still uncertain
- Negative earnings revisions by companies expected
- Bonds becoming attractive again

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

In Focus: "Stagflation" and "recession" scenarios

Do "stagflation" and "recession" go hand in hand?

The years of "easy money" are over. During those periods, it was possible to finance inherently weak business models and keep zombie companies alive with record low interest rates. With the newly restrictive monetary policy in place, the accompanying increase in insolvencies and a general slowdown in economic growth must now be absorbed, while liquidity on financial markets is becoming visibly scarcer. In contrast to past recessionary periods, key interest rates may remain high for longer this time. USA Inc. – which has benefited greatly from blatant monetary policy excesses over the past decade – is being hit hard by the higher cost of capital. Europe is also being weighed down by the costly realignment of its energy policy. The economic contraction differs from region to region, partly due to different approaches used to fight inflation. Profit expectations cannot be met as nominal sales growth is not sufficient to compensate for pressure on profit margins.

Investment ideas

- Underweight equities – prefer defensive sectors
- Bonds gain in attractiveness
- Broad diversification, including with alternative investments
- CHF as a safe haven currency
- Gold as a crisis hedge

OUT-OF-THE-BOX

Emerging markets – soon to be a phoenix rising from the ashes?

After almost three years of pandemic-related restrictions, Beijing is bidding goodbye to its zero-COVID policy. This U-turn will be critical for restoring the economic growth that underpins the legitimacy of the Chinese Communist Party. At the same time, the risk of overheating in the USA is increasing.
Although the Fed already tightened the interest rate screw in 2022, it is clear that the central bank will need to do more to sustainably tamp down inflation towards the 2% target. However, policy rates are rising too tentatively due to fears of systemic risks, pushing up long-term inflation expectations and generally causing the USD to weaken. In addition to China, the weak dollar is also helping a large number of emerging markets grow faster and stronger out of the crisis-plagued period compared to the European Union.

Investment ideas

- Cyclically sensitive equities (e.g. luxury goods, industry, small caps)
- Commodities
- Investments in emerging markets (equities and bonds)
- Avoid USD

Cajetan Bilgischer and Silvan Betschart

Interest rate scenarios

Opportunities and risks for an expected volatile year for investors

The economic environment remains challenging: Purchasing managers' indices are forward-looking and are currently below 50, pointing to a recession in the coming months. Central banks on both sides of the Atlantic are loudly proclaiming their intention to keep hiking interest rates (although perhaps more slowly) to fight inflation. For once, most economists are cautious and predicting a downturn.

In principle, it is important to question the consensus opinion and one should ask oneself how many negative factors are already priced into the market. We do not believe it is fully priced in, but the good news for investors is that right now there are investment alternatives outside the stock market with the potential of similarly attractive returns.

Consequences of interest rate normalisation

Key interest rates in the US have been raised to around 4.5% in 2022 and are expected to rise further towards 5% in 2023. Even though the US economy was clearly overheating before the first interest rate hikes and has shown itself to be relatively robust, this sharp rise in interest rates combined with higher energy costs and ever rising debt must have some sort of impact on the real economy. We expect a further weakening of real economic growth in Europe and, at some later point, also in the US. Only in China are there glimmers of hope that some momentum may build. The recovery process in China along with geopolitics are the key factors in determining how severe the recession in Europe will be.

Interest rate scenarios

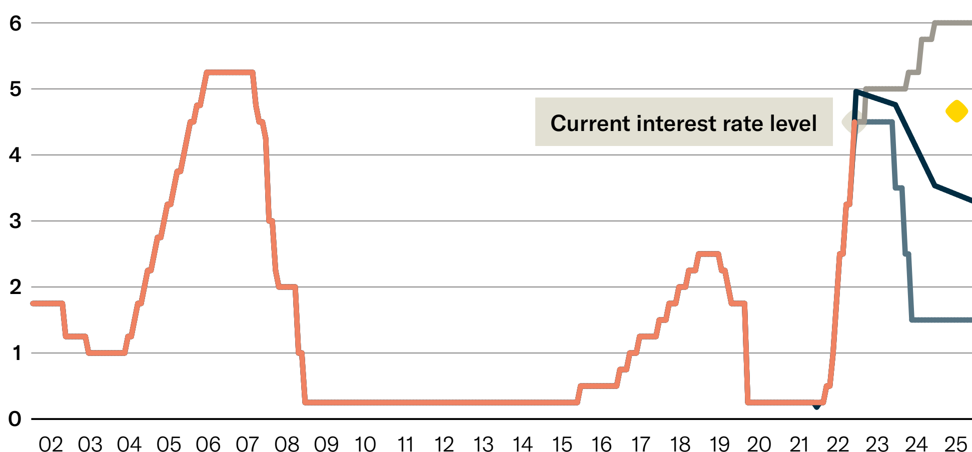
Interest rates follow inflation, but precise inflation forecasts do not exist. Even central banks often get it wrong with their forecasts. What will the next few months bring? In our view, three interest rate scenarios are theoretically plausible for the US:

A) "Higher for longer" scenario:
Given market expectations, this is the risk scenario for the stock markets. The employment market and core inflation remain overheated and, after a brief pause, central banks gradually lift key interest rates further towards 6%. The reassessment of interest rate expectations puts further valuation pressure on equities and risk assets. Cash remains the most attractive short-term investment.

B) "Market" scenario:
The rate hike cycle ends in Q2 2023 at around 5%. Inflation cools so much that the first interest rate cuts start in 2023. The recession is mild. In this scenario, we expect bonds to temporarily outperform equities, but for this to reverse in the course of the year.

C) "Rapid rate cuts" scenario:
The economy cools down more than the market expected so inflation quickly falls to acceptable levels. The US Federal Reserve responds with rapid interest rate cuts to prevent too much of a slowdown. With the new glut in liquidity, it is time to shift into risk assets. Quality and growth stocks are then in demand again.

ARE WE YET AT THE FED PIVOT?



A) Higher for longer – significantly rising inflation expectations

Our baseline scenario – FED takes a longer break in a mild recession scenario

B) Market scenario with significantly falling inflation and a moderate economic downturn

C) Back to the low interest rate environment with return to a deflationary climate

Source: Macrobond, Bloomberg (as of 21.12.2022)

Which scenario should investors position themselves for?
In the medium term, the key question is where inflation will settle. Even if inflation falls back in the next few months due to the base effects, there is unexpected upside potential in the medium to longer term. The energy market is still in a difficult situation. The development of local supply chains is continuing to fuel high demand for selected raw materials and skilled labour with higher wages. These are all supply-side bottlenecks, and we do see few signs of the respective supply side expanding. Therefore, in our baseline scenario, we forecast that interest rates cuts will not feature in 2023 and that US key interest rates will hover in the 4.5–5% range for longer than expected. Consequently, we are positioning ourselves for a recession scenario in which central banks will not immediately rush to the rescue (see Graph Page 4 ◆). As a result, in the short term, fewer equities should be held in favour of bonds. Alternative investments continue to be an opportune way of diversifying the portfolio, and market fluctuations are also opportunities, especially for active managers. Holding some cash in reserve is sensible and makes it easier to react when necessary. Depending on changes in inflation expectations and interest rates, there will need to be some flexibility in the tactical portfolio allocation in 2023.

When is the right time to increase the equity allocation?
In our baseline scenario, we do see a potential for negative surprises in companies' profit margins and a decline in earnings estimates for 2023. While equity market valuations came down significantly during 2022, earnings estimates have been largely immune. We do consider these to still be 10–20% too high – depending on the intensity of the economic slowdown. Only if earnings estimates begin to price in a recession will we see a trend reversal on the markets.

Patrick Erne
Head of Research

IN SHORT

Five specific investment ideas for 2023

Bonds: A mix of government bonds (as portfolio diversification for an unexpectedly severe recession) and corporate bonds with attractive yield premiums (to enhance returns).
For the best ideas, see page 6.

Dividend and value stocks: With the economic outlook uncertain, companies are well positioned if they have a business model with high pricing power, a flexible balance sheet, and the ability to be proactive thanks to a global presence. High dividend payouts facilitate attractive total returns in a sideways market.

Energy: Energy consumption is growing. At the same time, the Western world wants to move towards a more sustainable energy policy. For investors, this offers some attractive opportunities, from energy producers with high current distributions, to selected commodities, infrastructure assets and industry leaders in energy efficiency and management.

Active managers: We do expect a volatile year, which will favour active managers who can position themselves on both positive and negative market trends in the bond, commodity and equity markets. For those specialising in the credit market, we are expecting above-average return opportunities due to dislocations in some market segments.

Emerging market assets: Attractive in terms of valuations, emerging market equities may get a boost in 2023 as monetary policy is restrictive in many emerging markets and inflation is therefore less pronounced. If the USD weakens next year as the interest rate differential narrows, this will be supportive for emerging markets such as Vietnam, one of our regional favourites for 2023.

Opportunities in the bond market

Equity-like returns with comparatively higher protection against a recession

The regime of negative interest rates that has been persisting since the middle of the last decade finally came to an end last year. This makes bonds an investment category to be taken seriously again. Valuations on stock markets have normalised over the past year, but earnings estimates and therefore market expectations have eased only slightly despite the involved economic risks. These would have to be revised significantly downwards, especially in the case of a severe recession, which would in turn weigh on share prices. In contrast, the bond market is less affected by negative earnings revisions.

Market prices below nominal value

The higher interest rates may be a headwind for the stock market but they are also a tailwind for investors in the bond market. Higher interest rates mean coupons on new bonds are more attractive. Older bonds, which were issued in recent years at rock-bottom interest rates, can therefore be bought today for far below their nominal value, meaning private investors can potentially receive an attractive cash yield – despite a low coupon. And there is even the option of tax-free capital gains, with bonds building to the nominal value of 100 as they head towards their maturity date.

High yields on maturity

Risk-free interest rates, especially in US dollars, are moving back to levels not seen for around 15 years (currently 4.5%). Coupled with credit spreads at a historical average (5% for non-investment grade), this is pushing yields to maturity into the high single-digit percentage range (depending on the segment), so an attractive alternative to equity market investments is there for the taking. In difficult market phases, investors are better protected because bonds do have a better standing in the capital structure. With the redemption date, bonds also have an end date with a fixed payout amount, while equities may stay cheap or undervalued over a longer time horizon.

Opportunities depending on risk appetite

In a recession scenario, rates at the long end fall first while credit premiums rise due to the uncertainty. If you think there is going to be a severe recession, you should opt for government bonds for the short term, which benefit from falling interest rates. This is not our baseline scenario. In a mild recession, the drop in interest rates and the high current yield will compensate for an increase in credit premiums. In addition, only a few refinancings are due in the next two years. Therefore, the opportunities in the bond market outweigh the risks for us. After a longer period in which we considered the bond market to be less attractive, we now see more attractive opportunities for returns relative to equities in the coming months and are increasing the allocation accordingly. We would be happy to discuss specific options that best suit you and your personal investment goals.

Matthias Ramser
Chief Investment Officer

Bonds are back on the investment map

	Government bonds	Corporate bonds (investment grade)	High-yield bonds (non-investment grade)	Emerging market bonds	Subordinated bonds (Financials)
Opportunities	– No credit risks – Possibility of price rises if interest rates fall	– Defensive implementation	– Attractive yields	– High current earnings – Tailwind from USD weakness	– Solid capitalisation – Tailwind thanks to higher interest rate margin
Risks	– Interest rate risk if interest rates continue to rise	– Significantly rising long-term interest rates	– Severe global recession with high default rates	– Restructurings with historically low recovery value	– Recession with capital requirements for banks
Current yield expectation (USD)	3.5–4.5%	4–6%	6–10%	6–12%	7–10%

Is your estate in order?

Customised wealth transfer to the next generation

Taking the initiative and being proactive in life comes naturally to us. The same should apply to your estate. If you do not arrange matters, the law will handle your estate, leading to results that often do not correspond to your wishes as the testator.

Smart estate planning
The new inheritance law from 1 January 2023 removes the compulsory portions of parents and reduces the compulsory portions of children. This increases the portion of your estate which you are free to dispose of as you please – but only if you are proactive in planning your estate. We provide our clients with expert support in transferring wealth to the next generation[1]. Who should eventually inherit your assets? Do you want your spouse or partner to be financially secure? Should godchildren or charities benefit, for example? Who will continue to run your company? Are there any other important areas for you to consider? You outline your goals and we develop a customised concept that is tailored to your personal situation, your wishes, your asset structure and the regulatory framework conditions, incl. taxes. In the process, we design various scenarios and determine how assets should pass to the next generation depending on the scenario so you can achieve your targets. We do advise you on how to structure your assets and if you wish, remind you at regular intervals to review your arrangements.

Reviewing existing arrangements
Have you already arranged your estate (years ago)? As a general rule, it is recommended to review the estate deed every two to five years as well as when significant events occur – such as moving your residence, marriage, the birth of a child, divorce, inheritance, or retirement. Use this change in the law as an opportunity to revise your paperwork today. Many times, existing arrangements may be worded in a legally ambiguous way from a current perspective. It is frequently unclear whether the children should receive the compulsory portions under the old law or the lower compulsory portions under the new one, for example. These ambiguities can often lead to disputes in the event of a death, which then have to be clarified by the authorities. During a legal review of your inheritance contract or will, we determine whether your last will and testament is clearly formulated. If there are any ambiguities, we will find pragmatic solutions for you.

Lifetime transfer
Making a partial transfer of assets during your lifetime might be an astute move. The reasons for this depend on the individual case. Involving the next generation at an early stage can strengthen the family structure and be favourable from a tax perspective. If, for example, a property is passed on to a child, this often leads to (undesirable) unequal treatment between the children. With early consultation and careful planning, we can create transparency for you and your family and prevent disagreements between siblings.

Representation of heirs
Are you part of a community of heirs that has not yet been dissolved? This community of heirs is created by law after a death. Dissolving one – without executing a will or getting official involvement – requires expertise and can be time-consuming. We can advise your community of heirs as a representative of the heirs and draw up the estate division agreement on behalf of all heirs.

Execution of the will
If you wish, we can handle your estate as an independent executor. We will ensure that your estate passes to the next generation in accordance with your last will and testament. As an executor, we will administer the estate until it is divided, distribute legacies if necessary, and take care of administrative tasks. In the event of disagreements between heirs, we provide tactful mediation and reach a compromise solution.

Benefit from our expertise – we will be happy to advise you.

Astrid Niederberger
Estate Planning and Execution of Wills

[1] We advise exclusively according to Swiss law and involve experts for special local or international issues.

“What has 2022 taught us?”

Interview with Jürg Staub, General Partner

How will you remember 2022?
This past year was formative in many respects. There has been the war with its knock-on effects such as the energy crisis, sanctions, and the division of the world between democracies and autocracies. We’ve also seen the return of inflation and interest rates back in positive territory – money has a price again. For most investors, 2022 was a bad year. We have done well compared with the market, but it is always a painful task when I have to show our clients negative performance figures.

What lessons have you learned from the past year?
I’ve learned that sanction risks can quickly have a significant impact on your investments. I hold a few Russian securities for my family that I bought years ago in the commodities sector for long-term appreciation. Right now, we don’t know when or how we will ever be able to convert them back into money. My lesson from this is to only make core investments for purchasing power in countries where I could imagine myself living, These countries are the democracies of the world within the Western bloc. Other regions can be considered as opportunistic add-ons. Furthermore, 2022 confirmed that whereas farm and infrastructure investments and alternative diversification strategies have been very good for performance contributions, these illiquid or complex investments are not suitable for everyone. This drives home the importance of a personal investment strategy and the personally appropriate diversification.

How does this realisation influence your interactions with clients?
Our motto is “People and money in harmony”. It’s not always clear beforehand whether we can achieve this. Our core task is to regularly ask our clients the purpose of their assets and the strategy based on that, and to present other options with their respective advantages and disadvantages. This calls for a lot of experience and an open and critical mindset.

How do you ensure clients receive quality advice at Reichmuth & Co?
Ongoing training and transferring knowledge are always a priority for us. Collectively, we have a wealth of experience. I set a personal focus by accompanying customer service representatives when they hold strategy meetings with clients. Simply put, we can achieve more as a team than with each of us working alone. I’m glad that our continuity means we can count on a large team of experienced partners and customer service representatives. There are also younger professionals we can draw on. After all, these meetings are not only about investment strategy where we create added value for our clients, but also about various integral topics such as pension and estate planning, real estate, investing, financing and/or philanthropy.

What are your priorities for the new year?
Besides client meetings and coaching employees, I’m very much involved in further developing our business in Germany, as well as in the niche area of agricultural investments, where we have been able to identify huge potential and make major progress. Last but not least, I’m also engaged in association work on the governing bodies of the Swiss Bankers Association and the Swiss Private Bankers Association. I started my banking apprenticeship in 1982 and have been working for Swiss banks for over 40 years. I am able to give something back through taking on duties in a part-time or voluntary capacity so that the framework conditions in Switzerland remain future-proof and competitive.

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neutral
Drucksache
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