CHECK-UP

May 2023
Client information
Reichmuth & Co Private Bankers

Editorial

Stability is beneficial for an investor’s assets. Given the tumultuous headlines and numerous challenges, we are pleased to see that financial markets have stabilised this year after last year’s tough environment and that client custody accounts are performing well.

The recently arranged forced takeover of CS by UBS – imposed by emergency law – was not intended to expropriate, but rather to preserve stability. Size in itself does little to promote stability, nor does too much concentration. It is doubtful whether new laws or more regulations will do much for stability. A more effective way is for clients to take responsibility for their own decisions, which also applies to their choice of investment strategy and bank.

We look forward to assist you in these important questions.

Jürg Staub
General Partner

Domino effect?

Financial markets are still unstable. Interest rate hikes implemented by central banks to tackle persistent, excessively high inflation are having an effect – but so far only on the financial markets. The global rise in interest rates of between 2.25 % and 4.5 % pushed bond and share prices down in 2022. This year, banking problems have been exacerbating the situation and real estate and private equity markets will probably feel the pain. It is unclear when the domino effect will end.

Forgotten duration risks
Duration risk indicates how much the price of a fixed-income security will fall when interest rates rise and vice versa. The longer the term and the lower the current yield, the bigger the risk. This concept applies equally to equities: dividend gems are the least sensitive, while growth stocks respond most strongly. That is because their expected profits are far in the future and are discounted at higher interest rates. Even supposedly risk-free government bonds have

taken a hit in the wake of higher interest rates, triggering a liquidity crisis at US regional banks.

Unrealised losses

Banks which buy government bonds do not have to back them with equity capital. If the bonds are to be held to maturity, they do not have to be carried on the bank's balance sheet at market prices either. If interest rates rise, the hold-to-maturity book will incur unrealised losses. Banks which fund these purchases using client deposits transform short-term deposits into longer-term investments. In doing so, they have flagrantly neglected interest rate risk. Client deposits become increasingly volatile when interest rates rise. Money market investments in USD at 5% suddenly become a lot more attractive than accounts paying low rates of interest. But this is especially true if clients are concerned about the bank's solvency. The combination of these two factors led both to the run on Silicon Valley Bank and the subsequent arranged forced takeover of CS by UBS, and at unprecedented speed. In the digital age, billions can be moved within a very short period of time, all at the click of a mouse.

Lower or raise interest rates?

If central banks cut interest rates, it would put a stop to the flight from deposits to higher-yielding investments. But core inflation in both the US and Europe is still at 5.5%, which is far too high. It would erode the credibility of central banks and raise inflation expectations. However, financial stability takes precedence over fighting inflation: having the latter makes little sense without the former. Faced with this dilemma, we therefore expect central banks to consider the risks to financial stability when deciding whether to raise interest rates even higher. If they did, it would further exacerbate the problem of unrealised losses. This would have a knock-on effect not just on public equities and bonds, but also on those whose values are based on models rather than market prices.

> **"Tackling inflation effectively would require raising interest rates above core inflation, currently above 5%–6%."**

Dangerous domino effect

As has been the case in the past, the impact of a combination of rising interest rates, increased energy prices and banking problems will have a delayed impact on illiquid markets such as real estate and private equity. Although exchange-traded real estate equities have already corrected sharply in anticipation of this development, it is clear that private markets have not found an equilibrium yet. Sellers are still setting prices too high, 25 in times with zero interest rates, while buyers' price expectations have already adjusted to the new interest rate and financing environment. The real elephants in financial markets are the highly indebted countries. They will feel rising interest rates very acutely in their budgets. If their creditworthiness falters, it will likely be reflected in the exchange rates.

What to do?

If you share the market's view that inflation will soon be under control and interest rates head south again, or if you even expect a deflationary shock (e.g. a default by Italy), you may increase duration risks, which means choosing bonds with medium to longer maturities or buying more shares of growth companies. But we are more sceptical in this respect and are anticipating core inflation to be more stubborn with a prolonged period of elevated interest rates. Our preference is to stand by in cash and hold high-dividend shares.

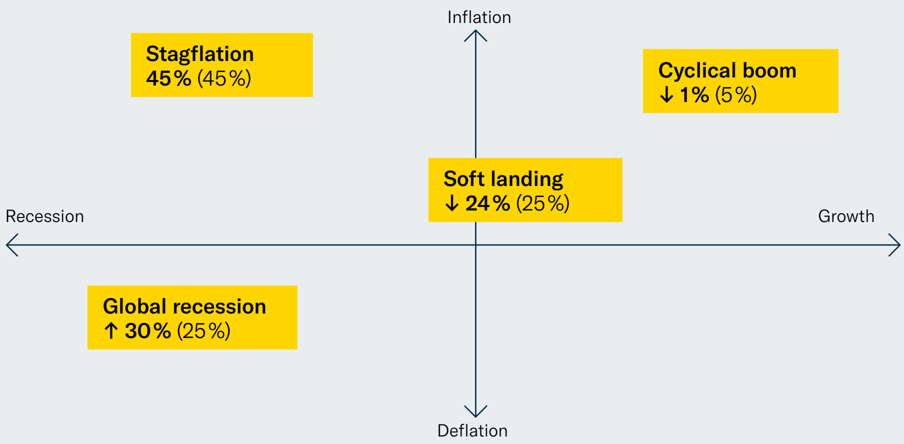
Depending on the priority and willingness to fight inflation of the central banks, specific strategies are required for specific regions. The risk of sacrificing inflation control for financial stability is highest in Europe, followed by the US. If this becomes apparent, the advice for the stagflationary 70s would be apposite today: hold cash in hard currencies, e.g. in CHF, and above all prefer high-dividend equities, complemented by real estate investments which are financed for the long term.

After more than a decade of an exceptional monetary policy involving zero and negative interest rates, it will take two to three years for financial markets to adjust to the new interest rate regime. We are in the first year. Therefore, it is still important to closely monitor inflation expectations, core inflation and interest rates.

Christof Reichmuth
General Partner

Scenarios and investment consequences

Stagflation as the most likely scenario



Current assessment

- High interest rates increase liquidity risks
- Lending by banks becomes more restrictive, which increases risks of a recession
- Lower in interest rate expectations overly optimistic in view of inflation figures and employment market situation
- "Soft landing" becomes increasingly unlikely

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

In Focus: "Stagflation" and "recession" scenarios

Our baseline scenario: Stagflation – interest rates remain high

Key interest rates peak in Western countries, but we do not expect a fast pivot in interest rates, as employment markets are still overheated. This keeps financing costs high and puts pressure on financial assets. Real growth in the economy softens and inflation stays stubbornly higher than the central banks' target.

Indicators which we pay particular attention to:

- Interest and inflation expectations, especially the core inflation trend
- Real estate prices and rents
- Oil price, which has a high weighting in the basket of goods
- USD, as a weak USD favours inflation

Consequences for the investment strategy:

- Bonds: Focus on low duration assets, inflation-linked bonds and cash
- Equities: Value and dividend stocks preferred over growth stocks
- Alternative investments: Gold, active trading strategies and farmland

Alternative scenario: Recession – financial stability at risk

Domino effects in the financial system increase. Central banks around the world are forced to abruptly change their course to safeguard financial stability. Interest rates fall across the board, some market segments even needs to be supported with liquidity. The employment market cools and concerns about potential deflationary effects grow. The real economy experiences negative growth.

Indicators which we pay particular attention to:

- Credit spreads and defaults
- Credit growth at banks
- Strong USD – results in liquidity bottlenecks for companies and countries indebted in USD
- High inventory levels at companies

Consequences for the investment strategy:

- Bonds: Increase interest rate sensitivity and avoid credit risks (especially highly indebted countries and companies)
- Equities: Prefer defensive sectors and large caps (healthcare and non-cyclical consumption) over cyclicals and small caps
- Alternative investments: Active trading strategies and gold

Cajetan Bilgischer and Silvan Betschart

Two worlds of interest rates

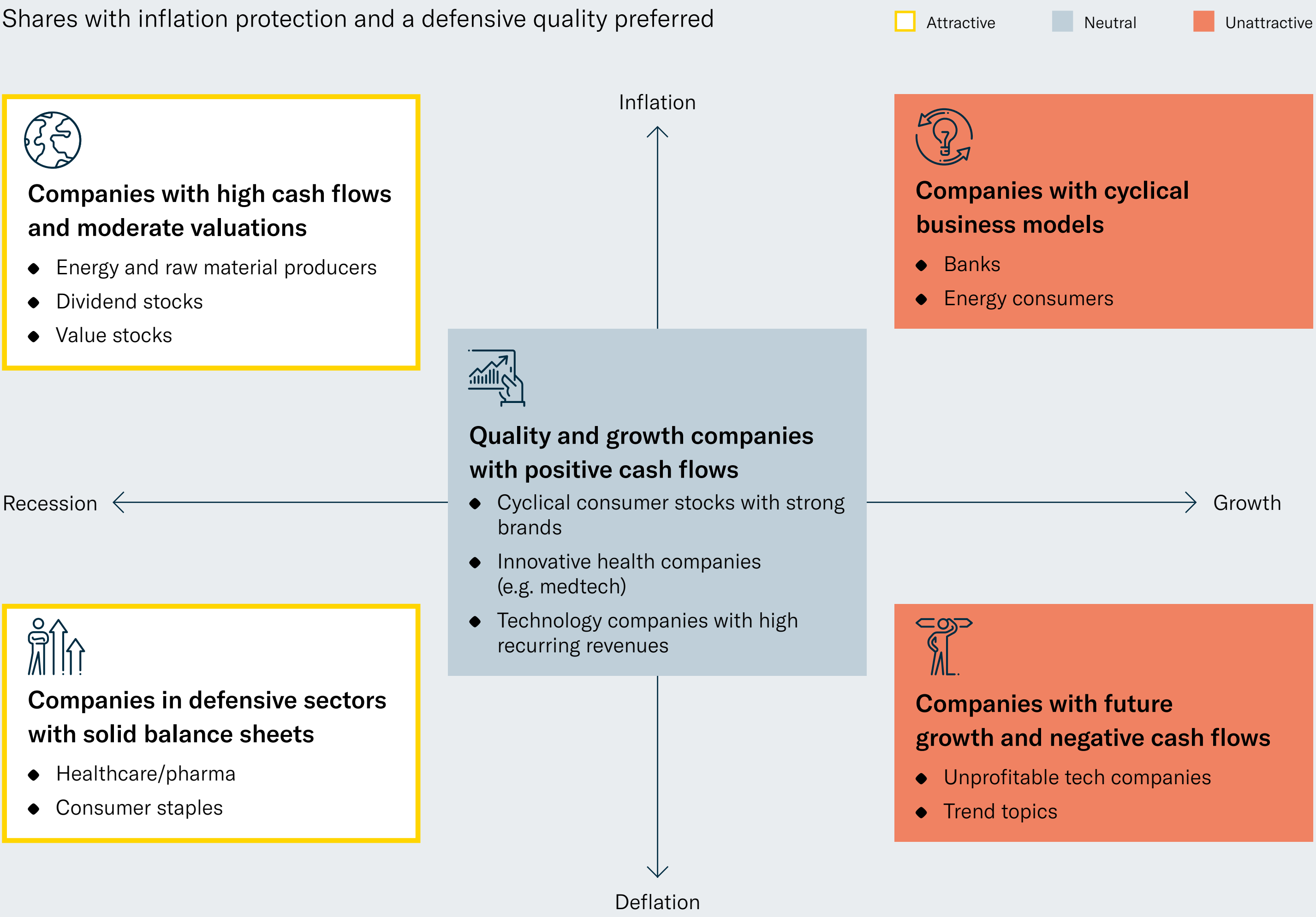
Is inflation or stability policy dominating interest rate levels?

The business cycle was surprisingly robust in the first four months of this year. But the impact of higher interest rates is becoming increasingly pronounced, as the recent turmoil in the banking world has shown. We are currently living through a period in which two different interest rate levels are required: a higher one for the global economy to lower inflation and a lower one to stabilise asset prices. This year, it is becoming apparent investors' expectations are oscillating between these two criteria, pointing to a trading market in which investors are constantly trying to reposition themselves. It is in precisely these phases where long-term scenarios can help navigate the ups and downs of the markets.

Interest rate market expecting a recession
While earnings expectations have been dialled back only slightly in the stock market, the interest rate market is already gearing up for a recession. The yield curve is inverted and three rate cuts by the end of the year have been priced in. Uncertainty has increased in the wake of the current banking crisis. But there is still plenty of liquidity in the system even if a large number of investors reduce their bank deposits and shift into higher-yielding money market funds. Liquidity is only withdrawn from the system when there are permanent write-offs in the form of insolvencies. And this has not happened so far. Structural inflationary pressures in the economy therefore are still

Which equities in which environment?

Shares with inflation protection and a defensive quality preferred



Last revised: April 2023

high and a wage/price spiral looms due to the tight labor market. Importantly, core inflation remains well above the central banks' target. Moreover, as we head into the 2024 presidential election in the US, the central bank is likely to be reluctant to influence the voting by taking bold interest rate decisions. Therefore, we do not believe central banks will lower interest rates by the end of the year as much as the market is currently expecting.

Stagflation or recession?

The common denominator in these two scenarios is anaemic real economic growth. In the recession scenario, the economic slump is more painful, as nominal growth will also collapse. This impact is less noticeable in the stagflation scenario, as sales and, to a certain extent, company profits will grow nominally with inflation. So equities would be preferred over longer-dated bonds in a prolonged period of stagflation.

Diversified stagflation portfolio

The focus of our investment strategy is on low interest rate sensitivity. This means that we prefer bonds with short maturities or inflation protection. For equities, we recommend a neutral weighting within the individual range. In selecting stocks, we focus on sectors which have historically outperformed the overall market during difficult economic periods: primarily quality and dividend stocks of large-caps in defensive sectors (see chart on page 4). We also continue to see energy stocks as attractive in an environment of elevated inflation, especially as the supply side remains constraint due to far too little investment in recent years. We are holding precious metals in the portfolios in case long-term inflation expectations become unanchored and shoot up. And liquid alternative investments will offer additional diversification benefits. We are focusing on flexible, short-term trading strategies with a low correlation to the overall market, active equity strategies which will benefit from a re-opening in Asia, and individual segments in the credit markets with high risk premiums. For anti-cyclical investments, some liquidity is also attractive in the current volatile market environment.

Second wave of inflation

Flexibility is needed in the current environment. Which is why we think in scenarios and can adjust the portfolio if the underlying situation changes. The focus here is on inflation. What if, contrary to market consensus, inflation does not sustainably ease, but in fact the opposite occurs? The risk of a second wave of inflation will become more acute if central banks reverse their restrictive monetary policy too soon before the economy cools down sufficiently, and if the employment situation does not deteriorate significantly. We could then be faced with a 1970s-type scenario where central banks had to hike interest rates even more to break the second wave of inflation. To compensate for the real loss of purchasing power in a phase of high inflation, we recommend increasing long-term positions in shares of high quality companies must be built up countercyclically. But this calls for increased flexibility and liquidity.

New credit default cycle in 2024?

If interest rates remain high, so too will the valuation pressure on financial assets, potentially causing stress in individual market segments. The segments most at risk are those dependent on external financing, e.g. in the real estate sector, consumer loans, but also an increasingly large share of private investments (private equity and loans outside the actual banking system). An indicator for this would be a strong slump in bank lending, rising credit spreads or defaults, for example. This would make the recession scenario more imminent. The recommended course of action here would be to reduce riskier investments further and invest in high-quality bonds with long maturities. Investment opportunities will be plentiful again, after a shakeout period.

Patrick Erne
Head of Research

Reichmuth & Co Lectures No. 22:

with **Prof. Dr. Dr. h.c. mult. Martin Hellwig**, Director (emer.) at the Max Planck Institute for Research on Collective Goods and **Prof. Dr. Heinz Zimmermann** of the Faculty of Economic Sciencesof Basel University

"Too Big to Fail" and the market economy:
What happens after the broke of Credit Suisse?

Wednesday, 31 May 2023, 5.30 p.m.
at the University of Lucerne

Further information and registration:
This is a public event

Focus on quality

Pricing power and solid balance sheets are key

Periods of heightened uncertainty are the right time to increase quality in the portfolio. Unlike factors such as growth, size or momentum, the definition of "quality" is less clearly established. Even "global leaders" are not completely immune tomarket fluctuations. But they are more resistant to crises. For us, a healthy balance sheet and sustainable business model with high pricing power are particularly important. This conviction is based on the premise that these companies make better use of their capital over time and thus operate more profitably.

Why invest in quality?

1. **Profitable even in times of crisis**
   A powerful brand, strong client loyalty and recurring revenues are often what makes quality companies stand out. This helps them use their competitive advantages for the own benefit and means they can gain market share over the long term. And companies with a firm position in the market can push through higher prices. Pricing power helps firms maintain margins, as they can set higher prices and cushion weakening demand, especially in phases of declining volumes. This is especially true for businesses whose products are in daily demand. These companies also often pay an attractive dividend, which grows with profits over time.

2. **Highly innovative and therefore adaptable**
   Quality companies are notable for having a long-term and sustainable business model. This includes ongoing investment in research and development. Thanks to this, they can continuously expand their market position and adapt to new trends early on, enabling them to build on their long-term competitiveness. Innovation sets a quality company apart and allows it to generate intrinsic value over time. In other words, a key feature of quality companies is that the capital reinvested by management will generate significantly higher returns than the effective cost of that capital.

3. **Capacity to act**
   Low debt levels is another aspect often associated with quality. Excessive debt has a negative impact on earnings and can cause financial distress. This, in turn, limits a company's ability to act. The international and often even global presence of a company reduces their dependence on individual sales markets further. A company's agility, especially in a challenging environment, can make the difference between being a winner or a loser.

Why invest in quality *now*?
Persistently high inflation and a global slowdown in economic activity – i.e. a stagflationary environment overall – are reasons for purchasing quality stocks with strong balance sheets, somewhat more defensive qualities and high pricing power. As a large number of market participants are generally willing to pay a little more for these positive characteristics, quality stocks often trade at a premium to the overall market. But higher interest rates and the accompanying fall in valuations over the past year have led to more reasonable valuations of quality companies. On balance, we consider this an opportune moment to increase the quality focus in the portfolio. Our client relationship managers will be pleased to recommend ways to invest in Global Leaders equities.

	Global leaders selection	MSCI World
Price-earnings ratio	18.3	16.6
Return on invested capital	21.4	14.4
Net debt/EBITDA	0.6	1.2
Profit margin	15.7	9.3
Median market capitalisation ($bn)	148.5	12.8

(Source: Bloomberg 11 April 2023)

Examples:

- Brand strength: L'Oréal, Apple, LVMH
- Research leadership: Novo Nordisk, ASML
- Recurring income: Microsoft, Kone

Aljosha Friedländer
Portfolio Management

"Better together"

New site in Zurich with three business divisions in one location

After 15 years at Tödistrasse, we moved our Zurich branch "around the corner" to Gartenstrasse 32. Combining the three business divisions – Private Banking, Pensions and Infrastructure – under one roof means we will be stronger and closer to our clients.

Dr. Stefan Hasenböhler, Urs J. Beck, Mark Huber, Remo Hegglin (left to right)

Urs Beck, 15 years ago you had the privilege of opening the Zurich branch for Reichmuth & Co. Looking back, what were the formative events during this time?
A look back reveals some parallels to today – for example, there was enormous uncertainty and dissatisfaction among investors was in autumn 2008. But just like today, trust was essential, i.e. providing continuity and individually tailored support. Our owner-managed private bank structure clearly fulfils a timeless need. Looking back, there was a period of exceptionally successful and steady growth based on a core of staff from the early days, which our previous limited premises had prevented. In retrospect, it was the high quality of service and team spirit, which was also conveyed externally, which had a large impact.

Mark Huber, you've been with PensExpert since day one at the branch. Do your experiences tally?
Yes, the joint location was the right step and a good one to take. We both wanted to quickly establish ourselves in the Zurich market and, of course, acquire clients. We were able to utilise the individual and flexible pension solutions within the rules of private banking in many joint client meetings. The Zurich market, which has a large number of companies, is also very important for us to attract private individuals with vested benefits in the event of a career change. Today, the region is one of our strongest in terms of turnover and growth. We look forward to continuing this joint success story on Gartenstrasse.

Stefan Hasenböhler, the infrastructure team has had to lease external offices in Zurich for the last few years. What are the advantages of doing things under one roof again?
Since the launch of our infrastructure business 11 years ago, we have actually been able to grow at a brisk pace. We invest directly in infrastructure assets in the areas of sustainable transport and renewable energy, which deliver stable returns and distributions and offer protection against inflation. To look after these long-lasting infrastructure investments, we need employees with specific specialist know-how, who we can best attract on the Zurich employment market. Having a shared location also promotes a dialogue with the bank and PensExpert. Thanks to this arrangement we can make better use of joint networks on the client side or draw on expertise in our Group-wide network for specific projects.

Remo Hegglin, you planned/implemented the expansion of the new branch and are taking on more responsibility locally under the succession plan. How did the change go and what is key for you looking to the future?
The seamless move into the new premises took place after a short and intense planning phase followed by a construction period of just four months. The open space plan is a real delight. Our colleagues from Lucerne and St. Gallen are also making active use of the new premises. We are particularly happy about the amount of positive feed-back we receive from our clients. I am convinced that our modern office space, which is appreciated both by our clients and our staff, puts us on an excellent path for further growth in the future. We look forward to welcoming you to Gartenstrasse!

Private bankers personally stand up for stability

Interview with Remy Reichmuth, CEO

2023 got off to a turbulent start, especially for banks. How were you and your clients affected?
The hikes in the base rate to fight inflation put pressure on bank balance sheets. The turmoil at some US banks caused risk premiums for banks to rise rapidly worldwide – which then resulted in a dead end for CS. We did not hold any CS shares as part of our investment strategy. Our analysts have been cautious about banks for a long time and prefer insurers within the financial sector, which also offer attractive dividend yields. Our trading division closely monitors counterparties and there are a handful of banks with open credit limits which we have kept very low for months. Here too, we were well prepared and not directly affected.

What about Reichmuth & Co's stability?
It is important to know that the securities obtained are directly held by the client and are kept off the bank's balance sheet. The only thing on our balance sheet is client liquidity. With three times as much equity than required by regulations, we are rock solidly financed. Because of the ownership structure, the unlimited liability of the shareholders is a factor in every decision. It upholds a fundamental principle on which we even published a book about 10 years ago, which I am happy to share with anyone interested: "Decisions and liability belong together".

How should the risk of a bank run be assessed?
Matching maturities of assets and liabilities is crucial. For example, banks with a substantial lending business have tied up client funds available in the short term for a longer period of time – and their equity often comprises only a small portion of the balance sheet. It's different for us as an asset management bank: the liabilities side is determined by the client's cash holdings. So we take a very conservative and liquid approach to our asset side. The majority is deposited on a one-to-one basis in liquidity with the Swiss National Bank – there's no counterparty risk here either.

Did correspondingly large numbers of clients who were disconcerted about the situation switch over to you?
Fortunately, we've steadily increased new clients in recent years. And this has also been the case in 2023. Some may have moved due to recent events – usually several factors cause someone to change banks. However, it's clear that the international perception of the Swiss financial industry is significantly impacted by the major banks. And we're part of this financial centre – so we suffer when it does.

What is the outlook for you?
How the merger of the two big banks will really affect their clients, employees and the banking centre is still unclear. Internationally, Switzerland's image of a place of legal certainty has been severely damaged. But reliability has taken less of a hit. With a share of around one quarter of cross-border assets under management worldwide, Switzerland is still the world's market leader. The country's direct democracy, political stability, the Swiss franc and so on, are still outstanding location advantages. We can continue to build on this and approach the future having learned the right lessons from the last few weeks.

How are you helping to shape this development?
For example, we're getting involved politically, including directly via the Bankers Association. True to Switzerland's federalist philosophy, I'm certain a financial centre is healthier if it has several strong, small banks rather than just a few big ones.

Anyone who is reassessing their advisory and administrative bank situation – we would be happy to apply.

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