CHECK-UP

September 2023
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Reichmuth & Co Private Bankers

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Editorial

Over the past year, the government bond bubble has burst and the real estate markets have also been deflating somewhat, but now a new, hot commodity with bubble potential has arrived in the form of artificial intelligence.

Fortunately, the extreme monetary policy of the last decade is a thing of the past. More worrisome, however, are the ballooning government expenditures.

It is precisely in times such as these that integral asset management demonstrates its greatest effectiveness. In uncertain and turbulent periods, it can be used to design a roadmap to ensure that personal goals have the best possible chance of being achieved, even when faced with a variety of scenarios. After all, wealth should not be primarily a source of worry or stress for asset owners and the next generation – it should bring peace and security.

Jürg Staub
General Partner

«Corrective interest rates»

A quick look at the financial markets shows that they have made a pretty good recovery after last year's interest rate shock. This could not be taken for granted, however, since it is not just nominal yields that have risen. Real yields in the US have also jumped from minus 2% to plus 2%. Under normal circumstances, such a development would be followed by financial markets stabilising at a lower level, but the continuing high monetary overhang and the current hot topic of artificial intelligence have caused asset prices to rise instead. This year's price gains are primarily due to valuations (P/E expansion) rather than profit growth.

From de-coupling to de-risking

Whereas the US wants to increasingly decouple itself from China with the "Infrastructure and Jobs Act", the "Chips and Science Act" and the "Inflation Reduction Act", Europe is leaning more towards "de-risking". The interconnectedness with China is certainly too great. Yet it is also desirable for companies not to become overly reliant on China for their supply

chains. Even in Europe, politics is increasingly intervening in the economy. Europe's version is called the "Green Deal", and it aims to drive forward the de-carbonisation of the economy to combat climate change.

New appetite for industrial policy
As we can see, the old paradigm of "everyone benefits from globalisation and free trade" is coming to a definite end. "Modern" industrial policy is gaining supporters. Protectionist interventionism with bans, taxes, incentives and subsidies is gaining momentum, but this type of economic policy often means additional public debt. What are the limits of this state interventionism? Since all of that money can be used to mobilise broad voter groups in favour of such policies, the necessary correction is much more likely to come from the interest burden. Since 2010, the US national debt has risen from around 13 trillion to over 30 trillion, which is approximately 120% of the country's GDP. With near-zero interest rates, the government's budget is barely affected, but interest rates above 5% are a heavy burden. At that point, interest costs can quickly surpass the size of the enormous US military budget, for example, creating political pressure to pursue a more sustainable fiscal policy. If that does not succeed, rising long-term yields or a depreciating currency will do the job. That is why long-dated USD-bonds seem risky to us.

Higher for longer
Central banks are now serious about tackling overly high core inflation. A more restrictive monetary policy involves a combination of higher interest rates and quantitative tightening, i.e. reducing the high volume of bond holdings. This applies both to the USA and to Europe, where Christine Lagarde was admittedly very late in adopting a more restrictive course, but has since done so emphatically, suggesting that interest rates will remain high for a longer period – barring a new financial crisis.

High monetary overhang
After a decade of extraordinary monetary policy measures, raising interest rates is a delicate balancing act. There is simply too much money in the financial system, as can be seen from the balance sheets of the major central banks. Central banks have to reduce their holdings of government securities they have purchased, but also pay interest on the reserves, i.e. the deposits of commercial banks at the central bank. This has two effects: firstly, the national budget is now burdened with higher interest rates, and secondly, the banks' interest revenues have increased. Both effects are unpopular, which has already led to the first populist measures emerging, such as the recently imposed windfall tax on the interest earnings of Italian banks. The banking crisis in spring seems to have already been forgotten, although still high unrealised losses are lying dormant on the books – and not only on those of the banks. These include longer-term investments, i.e. loans, bonds and financial assets from the low and negative interest-rate period that – despite the rise in interest rates – are not recorded at lower market values in the books. For investors, the high monetary overhang means that, barring external shocks, valuations of real assets are likely to remain optimistic.

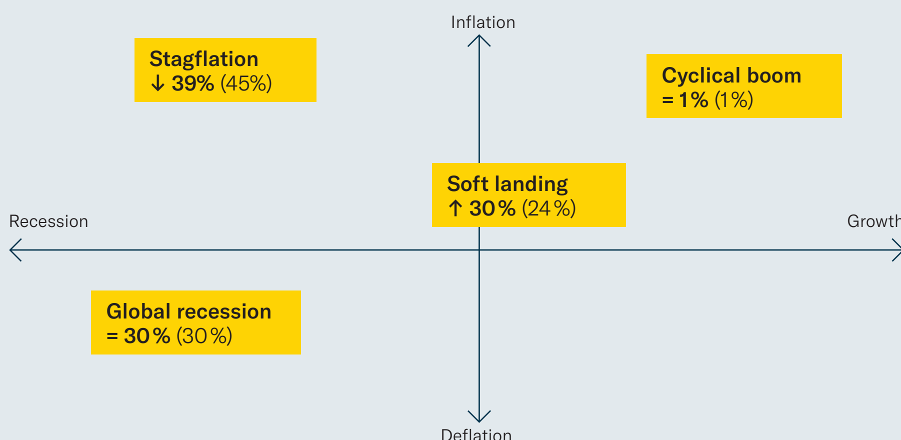
"Artificial intelligence" – A bubble in the making?
On the one hand, investors purchase investments based on fundamentals, i.e. expected future returns. Speculators, on the other hand, buy with the expectation of selling their investments at a higher price later on. Due to the wide prevalence of benchmark thinking, even long-term investors are remaining committed to bubbles for longer – otherwise they would lose their benchmark clients. Artificial intelligence has the potential to become a valuation bubble. It is a cross-sectional technology and impacts all industries. At any rate, it would be a bubble that holds the promise of future productivity gains. This is less dangerous than normal valuation bubbles, such as in the real estate sector of the late 1980s, or the one that preceded the financial crisis of 2008 in the USA. We are closely following the topic of artificial intelligence to find the companies that can quickly learn what this technology represents for their business and how to use it.

What is the best course of action?
Uncertainty remains high, but the financial environment seems to be recovering. Which is why we are advising investors to stick to their long-term strategy. In general, we are expecting an environment of higher interest rates, with yield curve inversion (short-term yields higher than long-term ones) to be offset. This makes holding cash and adopting a wait-and-see attitude more compelling than long-term bonds. In contrast, the equity risk premium is currently low. Nevertheless, for long-term investors we still prefer stocks, especially those of high-dividend companies, as these help to preserve real value. Personally, I like dividend darlings and cash-flow generating investments, but temporarily holding cash also has its appeal. After all, the next crisis is bound to arrive at some point, and it would be a pity not to be in a position to act, since that is when the big opportunities present themselves. As every businessperson knows: "the profit is in the purchase".

Christof Reichmuth
General Partner

Scenarios and investment consequences

From a soft landing for now towards a recession



Current assessment

- US economy proves more resilient than expected despite a sharp rise in interest rates
- Recession risks in the US staved off for the time being
- Stagflation remains our main scenario over the medium term

Scenarios – estimated probability of occurrence, amount from last publication shown in brackets (May 2023)

Contrary to expectations in spring, the US economy appears unaffected (for now) by the sharp rise in interest rates. With declining inflation and a continuing strong labour market, the stock market is currently pricing in a soft landing. This has become more likely in the short term, but in our view, the recession risks for 2024/25 remain underestimated, because – among other things – China will no longer come to the rescue as the locomotive of global growth.

Market scenario: Soft landing

Declining inflation rates and a still sound labour market are injecting confidence into markets. The cycle of interest rate hikes in the US is coming to an end. Multinationtional companies have financed themselves for the long term and are barely affected by the high interest rates. Although real growth is historically low, a recession is being kept at bay for the time being, thanks to extensive fiscal stimulus.

Indicators which we pay particular attention to:

- Interest rate expectations, reductions
- Wages, core inflation

Consequences for the investment strategy:

- Equities: Maintain a high weighting; buy lagging segments in anticipation of increasing market breadth; stick with relatively expensive quality shares
- Alternative investments: Specialists that profit from heterogeneous stock market trends

Alternative scenario: Global recession

As we already witnessed in 2000 and 2006, when markets expected a soft landing, it will also not materialise this time around. The full effect of high interest rates on the economy starts to unfold some 18–24 months after the first rate hike. The Federal Reserve, based on the experience of the 1970s, will not lower interest rates very quickly, leading to faltering economic growth and a rise in credit defaults.

Indicators which we pay particular attention to:

- Labour market data
- Credit spreads and defaults

Consequences for the investment strategy:

- Equities: Reduce weighting; focus on defensive sectors and large-cap companies
- Bonds: Increase interest rate sensitivity and avoid credit risks
- Alternative investments: Low correlation to the stock market

Cajetan Bilgischer and Silvan Betschart

"If I were you..."

Integral asset management always focuses on your unique situation

The banking landscape in Switzerland is going through an upheaval – how are you experiencing this with your clients?
Adrian Bischofberger (AB): The developments during the spring were disturbing for many – and particularly for those working in the financial sector. In such phases, investment performance remains a topic of interest in discussions with clients, but other topics such as the security and capital strength of the banking partner or their corporate culture and incentive structures also become a priority.

What advice do you give to your clients?
AB: Maintaining a complete overview of all your assets is crucial. This "integral" view of investments, real estate, liabilities, pensions, shareholdings, cash flow planning, expectations and goals is the foundation for a comprehensive assessment of a client's individual situation.

Is this the best way to identify and coordinate opportunities and risks?
AB: Yes. The more information we have about the individual situation, the better we can formulate a basis for decision-making and advise our clients.

What is the best place to start?
AB: We often take on the role of "personal CFO" for our clients. Depending on the area of expertise, we will also call on specialists – internally or externally. A common first step is to align one's retirement provision with one's private assets.

Why is this integral alignment particularly worthwhile for retirement provision?
Marco Danelli (MD): By structuring retirement provision in the "right" way, we can offer direct, quantifiable added value thanks to tax optimisations. To accomplish this, we analyse the pension fund structure for business owners and demonstrate which tailored optimisation options are the best match for the individual needs of the client. At the same time, we create an ideal structure for withdrawing these funds.

Can you provide a concrete example?
With buy-ins into your individualised, non-mandatory pension fund solution! In Switzerland, these buy-ins can be deducted one-to-one from taxable income, which directly reduces your tax bill. Furthermore, you can use the entire range of options available when implementing your investment strategy. High-yielding investments – such as dividend shares – are best implemented within your pension plan since they are exempt from income tax. On the other hand, it makes more sense to hold high-growth investments, such as technology shares and gold, in your private assets because capital gains are tax-free. Using this structure enables you to achieve a substantial additional return thanks to the tax advantages. Calculated over ten years and depending on the canton, this strategy can result in an additional return that is 2–3x higher than what you would earn without these measures.

As mentioned above, the banking landscape is in upheaval, and the labour market is also undergoing a transformation. What should be taken into consideration when changing jobs?
MD: Leaving a company offers a tremendous opportunity to optimise

Specific questions that need to be answered in the integral view include:

- Do my choice of strategy and type of mandate (asset management, investment advice, etc.) match my expectations and goals?
- How do I structure my retirement provision? Is there unused potential in my pension fund, vested benefits or 3rd pillar?
- Is my pension planning, including the list of measures and withdrawal plan, clear?
- Given the new interest rate environment, do I need to make changes to the financing of my real estate?
- Are my direct holdings being kept in an efficient structure, and are the regulations regarding proxies and succession clear?
- How can I make charitable contributions in a meaningful and efficient way? Is it worth setting up my own sub-foundation?
- Do I and those around me know the full extent of my other material assets such as art, jewellery, cars and wine? Would it make sense to have an inventory in a supplementary custody account to gain a better overview?
- How do I protect my immediate environment with regard to death, disability, etc., and how do I organise my estate in a conscientiousness and self-determined manner?

Are you interested in a non-binding assessment of your integral starting position? Feel free to give us a call.

f.l.t.r. Astrid Niederberger, Attorney at Law, Marco Danelli, Partner, and Adrian Bischofberger, Client Manager, under discussion.

your personal retirement plan. The existing pension assets remain within the second pillar under vested benefits and can be managed in an entirely individual manner in accordance with the statutory investment guidelines. It is also possible to continue the risk benefits in the event of death or disability after leaving a company. The tax optimisation possibility of splitting the vested benefit assets between two custody accounts offers another significant advantage. It also increases flexibility with regard to a staggered withdrawal.

What specific issues need to be addressed and when?
MD: Your current phase of life definitely provides a key starting point of what to do.

- Aged between 30 and 40, the focus is often on providing for your partner or family in the event of death or disability.
- Between 40 and 50 years of age, it shifts to wealth accumulation, ideally including your individual occupational retirement provision and the personalised tax planning that goes along with it.
- At the age of 50, you should start considering financial and pension planning, with tax optimisation playing an even greater role at this point.
- As you near the age of 60, succession and estate planning gradually become more important.

What is particularly relevant to consider when planning an estate?
Astrid Niederberger (AN): These are the four most important things:

1. Your personal goals
2. The inclusion of all existing assets – which also means life insurance, pension fund assets, etc.
3. Both your personal and family situation
4. The regulatory framework conditions

What does that mean exactly?
AN: Transferring assets always prompts follow-up questions, such as custody of the mandatory portion, valuation, taxes, or affordability. When you are familiar with the integral view, you can set an optimal course during your lifetime, receive answers to follow-up questions, and at least provide cushioning against potential consequences.

What should I bear in mind if I transfer shares in a company or real estate to my child during my lifetime?
AN: The law stipulates that the mandatory valuation of these assets will only be carried out upon death. Children who are the recipients of such a gift may then find themselves in a financial bind if the parental property has increased in value between the time of the transfer and the death of the parent. Careful planning before the transfer involving all the heirs creates clarity and prevents future disputes when settling the estate.

At the moment, why are you strongly recommending a review of the existing estate planning regulations?
AN: The inheritance law that came into force at the beginning of 2023 often causes confusion with regard to existing regulations. I have already been able to provide many clients with an independent second opinion on the existing regulations. It is also worth your while to review the regulations every five years or, at the latest, when life-changing events occur, such as a marriage, moving in with a new partner, buying a house, starting a family, divorce, receiving an inheritance, or retiring.

What do I need to do if I want to achieve the optimal integral approach?
AB: The first step is always to sit down with an adviser face to face – even in the current age of AI. Our ambition is to align your assets and financial obligations with your realistic goals and wishes. Feel free to give us a call. We look forward to sharing possible solutions with you that match your unique situation.

Why interest rates remain higher

And what that means for investors

The experiences of the 1970s demonstrated that combating inflation is a lengthy process – and inflation can fluctuate greatly during that time. Anyone who had expected a quick end to that inflationary phase after the first spike was disappointed in the following years. Nevertheless, the current decrease in inflation and the AI-related share price fireworks during the last few months are fuelling hopes of a rapid end to this stagflation phase. Has the baseline undergone a lasting change, and does it require adjustments to the strategy?

Lower key interest rates on the horizon?

At the core of a positive soft landing scenario is the belief that the Federal Reserve will cut interest rates in time to prevent a significant rise in the US unemployment rate. Both the Federal Reserve and fixed-income markets expect US key interest rates to settle in the range of 4.5% by the end of 2024. The Taylor Rule is an old central bank formula that sets the "optimal" key rate based on current core inflation and unemployment. When inflation is high and unemployment is low, a higher key interest rate is justified – and vice versa. According to this rule, given the current data the US key interest rate should be at 8.7% today and be lowered gradually with the expected decline in inflation over the next few months. However, if one applies the rule using the market's expected data on inflation and unemployment over the next 12 months, the result is still an appropriate key interest rate of over 5%.

Therefore, we are doubtful that key interest rates will actually fall as quickly as the fixed-income market expects (barring a major incident, of course). Not least because elections are due in autum 2024 and monetary policy decisions are not intended to influence the outcome of the elections, we continue to keep interest rate risks low. In the fixed-income segment, we prefer short-dated quality bonds and money market investments rather than long-dated government bonds.

Key interest rate forecast	Ideal interest rate according to Taylor Rule*	Expectations		
		Central bank	Fixed-income market	R&CO
Currently 5.50%	8.7%			
2023	7.5%	5.6%	5.5%	5.5%
2024	5.3%	4.6%	4.4%	5.3%
2025	4.9%	3.4%	4.3%	4.0%

*Calculated with Bloomberg consensus estimates for inflation and unemployment
Data per 28.08.23

Increasingly positive sentiment among investors

The topic of artificial intelligence has steered investor sentiment in the stock market into positive territory. The prospect of above-average growth is attracting capital to this segment. As risk premiums are generally thin in many areas with the rise in interest rates (the expected earnings yield for the US equity market of 5% is now only slightly above the 10-year yield of 4.2%), we are placing a particular priority on quality in addition to valuations in our selection.

> **In the strategy we prefer real assets such as equities over nominal investments.**

We prefer companies that are already generating a high cash flow, that are not dependent on external funding sources, and do not rely on a single product. Quality stocks are certainly not immune to a decline in valuations, but the risk of getting into trouble due to persistently high financing costs or an economic slowdown is small. Following up on the analogy we began with, the 1970s also showed that revenues at many of these companies were able to grow nominally, which cushioned the pressure on margins and protected against a loss of real purchasing power in the long term.

Patrick Erne
Head of Research

AI as a driver of innovation

Productivity boost in Swiss industry? A short practical report.

Everyone is talking about AI. Many are excited about its potential, while others are expressing concerns. Experts (and non-experts) are all trying to assess what impact it will have on the future. However, what effect is AI actually having today? In our discussions with Swiss industrial companies, we see over and over again how the integration of AI is growing in importance.

AI not only gives companies the opportunity to boost their competitiveness, but can also optimise the efficiency and productivity of their business processes. Implementing AI algorithms makes it possible to analyse data in real time and make precise predictions, which then enables resources to be used more efficiently. Automating workflows can reduce operating costs while increasing product quality – a crucial factor for a company's long-term profitability. In practice, AI usually involves machine learning, i.e. self-improving pattern recognition or models that can process a large amount of data in a structured manner.

More efficient production processes

At Bucher Industries, for example, seeders can now recognise weeds based on patterns, and street sweepers are being developed that can drive autonomously with AI, avoid obstacles and identify rubbish on the road. At Komax, the market leader for automated wire processing, an innovative image evaluation algorithm can analyse a high-resolution colour image and map the entire production process. In addition, the system detects production errors using intelligent colour recognition. AI is also vital for the implementation of the Komax Smart Factory, which contains a "self-optimising factory" component. This is where Komax intends to provide its customers with cloud-based algorithms based on production and behavioural data from their machinery, enabling them to significantly improve their capacity utilisation and reduce quality costs.

Increase customer value

By integrating machine learning and data-driven decision-making, companies can better understand their customers and offer tailored solutions. This strengthens customer loyalty and enables a more targeted approach to marketing products and services. SFS Group is experimenting with solutions such as ChatGPT, CopyAI, Synthesia and Midjourney to generate content for different communication channels. AI is also used on a selective basis for translations and specific software functions, e.g. in content management. According to SFS, AI offers the potential to reduce costs and save time. But it can also lead to content becoming more generic and exchangeable.

Who benefits?

We can see two categories of beneficiaries. One is suppliers to the semiconductor industry, which could benefit from higher demand, and software service providers, since AI applications only run on the latest devices. The other category is companies that involve their employees in this transformation process and are implementing AI themselves. Cultivating a culture of openness to innovation and giving employees the opportunity to develop their skills and acquire new competencies for interacting with AI is essential. Artificial intelligence can propel Swiss industry forward and become a driver for innovation and growth. This technology's development is only just taking off, with the greatest advances expected to be made in the next few years. As is often the case with groundbreaking innovations, commercialisation can take longer than expected, but subsequent growth rates are then all the more robust. It remains to be seen who will be the ultimate winners, but at this stage we are placing our bets on a basket of companies from the two aforementioned categories of beneficiaries.

Philipp Murer
Portfolio Management

AGENDA

"2024 Market Outlook"

Our traditional private client events will take place this year as follows:

Lucerne:	Mo, 13 Nov. 5:30 pm and Mo, 20 Nov. 6:30 pm
St. Gallen:	Th, 16 Nov. 6:30 pm
Zug:	Mo, 6 Nov. 6:30 pm
Zurich:	We, 8 Nov. 5:30 pm and Tu, 14 Nov. 6:30 pm
Essen (DE):	We, 22 Nov. 7:00 pm
Munich (DE):	Tu, 28 Nov. 6:30 pm

Invitations will be sent out at the beginning of October.

What type of investor are you?

Dr. Matthias Ramser, CIO, under discussion

Stock markets have performed well in 2023 – what is your assessment?
At the end of 2022, we pointed out that disappointing years on the stock market are usually followed by a period of recovery, so this did not come as a complete surprise. However, the markets performed very robustly against a backdrop of familiar problems such as inflation, rising interest rates, and the division between an East and West bloc. Investors who followed through with their long-term strategy and did not panic were rewarded.

In your view, are there any special insights to be gained?
The last few months have demonstrated very clearly that if you think relatively and primarily compare yourself to the market, you should never stay "uninvested" for too long, as it is often difficult to re-enter into the market. I can cite countless examples where an exit in difficult phases was successful to some degree, but the re-entry failed completely. And those who think in absolute terms should not let themselves become too greedy by good market performance, especially in the case of stocks that have shot up in value – such as those connected with artificial intelligence. Sooner or later, reality will always catch up with prices. In my opinion, it is really important to be absolutely certain about whether you are primarily a "relative" or an "absolute" thinker.

Some stock indices are dominated by a handful of securities. Does active asset management still pay off?
In general, fear and greed regularly provide opportunities for active portfolio management. Those who invest passively in an index are also expecting the largest-capitalised companies to continue delivering the best performance in the future. History shows, however, that this has rarely been the case over long periods of time. The environment is shifting, successful business models are being copied, and regulatory conditions are changing. In the long term, for example, small/mid caps are also generating a structurally higher return, which is why adding them still makes sense.

It is really important to be absolutely certain about whether you are primarily a "relative" or an "absolute" thinker.

Or if you consider bond indices, highly indebted companies and governments typically have the highest weighting. Nevertheless, a high debt load – especially in a rising interest rate scenario – is anything but a quality feature worth investing in.

Which investment ideas are your personal favourites at the moment?
Firstly, we have been committed to the energy investment theme for some time now, and current valuations allow us to sleep soundly at night. Secondly, the biotech segment. Although it is currently suffering from increased financing costs, the pressure on big pharma to buy into innovation is always increasing. And thirdly, I see great opportunities in emerging economies. Valuations are favourable in many markets, and the problem of inflation is less pronounced than in the West because central banks are more disciplined and cannot print money arbitrarily.

What are your views regarding cryptocurrencies?
Opinions differ widely on this subject, and investments are highly speculative. Personally, however, I hold some Bitcoin, considered digital gold, and Ethereum, which is programmable money. There have been some recent scandals in this segment, and more frauds are sure to follow. What has been remarkable, however, is that the large networks have functioned flawlessly throughout. When safely stored in a regulated environment, which we have been offering for a few months for clients interested in this segment, BTC and ETH can be an exciting, speculative addition, in my view.

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