PRIVATE CLIENT LETTER

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WEIRD CONDITIONS

A series of indicators signal extraordinary circumstances in the economy and markets. At least cash and bonds are once again yielding interest. Nonetheless, navigating a course remains challenging.

"How the Economic Machine Works" is the title of a study by the well-known hedge fund manager Ray Dalio that was published a few years ago. The highly illustrative explanatory video that accompanies it depicts the economy as a gigantic mechanism of perfectly interlocking gears. It creates an image of constant waves of boom and bust, essentially controlled by two strong hands operating two large levers: the central bank with interest rates and the government with the fiscal budget. When interest rates are set to "low" and government spending to "generous", a "boom" occurs, while the opposite results in a "bust". In addition, there are very long cycles of 75–100 years in which debt, over-indebtedness, debt reduction, and renewed debt occur in turn, inspired by Soviet economist Nikolai Kondratieff's theory published in 1926.

The somewhat mechanistic depiction of the economy as a machine has a long tradition, with its beginnings dating back to 1758 with the "Tableau économique" by the French physician François Quesnay. However, Quesnay did not use gears but rather the circulatory system of the human body as his analogy. Both concepts share the notion that a machine or body will function reliably and predictably as long as it is not defective or ill. There are clear laws, predictable and (mathematically) calculable processes, and corresponding possibilities for interventions and corrections. This is an attractive image because in such a world, investors, entrepreneurs, or politicians could navigate with relatively simple means and good prospects for success.

A spanner in the works

A well-known thermometer for measuring the health of an economy is the yield curve. This curve represents the interest rates on government loans across various durations, ranging from days or months to several decades. In normal times, long-term loans typically come with higher interest rates than shorter-term ones. Borrowers can take on other risks and generate corresponding returns, while lenders are only willing to commit their funds for longer periods if they are compensated with higher interest rates.

Due to this economic logic, it is rare in a functioning market economy for long-term loans to have lower yields than short-term ones. Such inverted yield curves have been observed in the USA only a few times since 1980. They rarely lasted longer than a year and were typically associated with crises (the dot-com bubble in 2001, the financial crisis in 2007, and Covid-19). So it is remarkable that the yield curve has been inverted in most industrialised countries since mid-2022. In the

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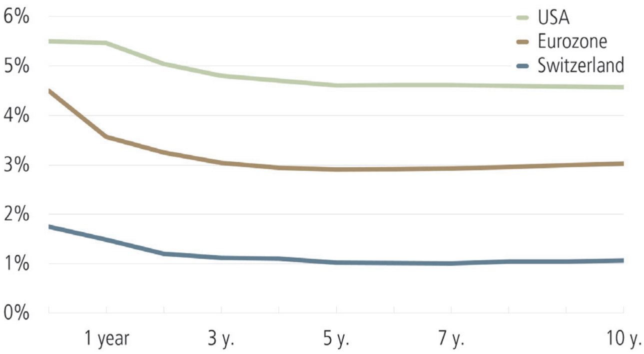
USA, it is already being referred to as the longest and most pronounced inversion in decades. The spread between 1-year and 10-year US government bonds has intermittently topped 1.5%, the highest level since 1981. The chart below depicts the currently inverted yield curves in the USA, the eurozone and Switzerland.

YIELD CURVES UP TO TEN YEARS, USA, EUROZONE (AAA), SWITZERLAND

Short over long



Quelle: Bloomberg, as at 29.09.2023.

Inverse yield curves can have many causes. A key factor is market participants' expectation of a decline in inflation and thus interest rates – in the worse case, due to recession and/or lower investment returns; in the better case, due to the resolution of supply bottlenecks, reduced scarcity of raw materials, or technological progress. It is also possible that market participants do not anticipate capital supply shortages because they expect governments or central banks to simply print more money in such cases. Not least, it is conceivable (but as yet still unlikely) that the government has pushed private investors out of the long-term bond market, and the interest rate no longer accurately reflects their expectations. To sum up, in contrast to the rumours, inverted yield curves do not necessarily herald recessions. They are simply a signal of extraordinary circumstances. Whether they are warning signs of an "illness" or a side effect of an economic recovery depends upon one's interpretation.

Conditions on the money market are also exceptional: for over twelve months, the risk-free central bank interest rate in Switzerland (and elsewhere) has been significantly higher than interest rates on bank accounts, call deposits, or fixed-term deposits – contrary to all economic logic. We have been observing this development with growing frustration, and in light of the ample profits reported by banks, the public is also beginning to realise that while higher interest rates on loans are immediately passed on, interest on deposits rises very slowly, if at all. Apparently, banks need not make much effort to attract capital, perhaps because there is still an (overly?) abundant supply of it from the era of low interest rates. However, competition seems to be functioning rather poorly than otherwise: the hurdles for changing banks are so high that hardly anyone goes through the trouble. This definitely represents a spanner in the works. Therefore, since mid-2022, we have been exploiting all options for an appropriate return in our client portfolios, whether through SNB bills, short-term government securities, call and fixed deposits, money market funds, or even by establishing additional banking relationships.

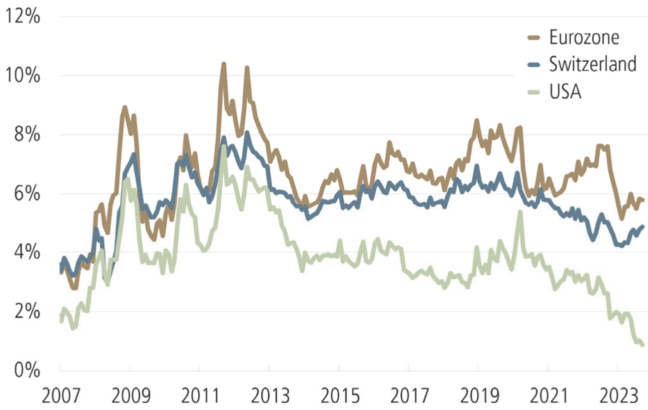
Acceptable alternatives

The shifts in credit markets are not without consequences for investors. On one hand, it is gratifying that bonds and liquidity (despite the frustration over the opaque money market) are once again generating returns. On the other hand, the question arises whether one should reduce equity holdings in favour of bonds. In times of zero and negative interest rates, the catchphrase for stocks used to be "TINA" (There Is No Alternative). However, for some time now, the acronym "TARA" (There is A Reasonable Alternative) has been making the rounds. An asset class is being roused from its long slumber.

A good measure for assessing the appeal of stocks relative to bonds is the equity risk premium. This metric compares the expected corporate earnings for the next twelve months, as estimated by analysts, to the current stock price. This so-called earnings yield for equities is then compared to the yields of relatively low-risk 10-year government bonds. The following chart depicts the risk premiums for the broad MSCI equity indices in the USA, the Eurozone and Switzerland. These risk premiums rose significantly across the board after the 2007 financial crisis and, until the end of 2021, averaged somewhere between 4% and 6%. There was adequate compensation for higher equity risk.

EQUITY RISK PREMIUMS USA, EUROZONE AND SWITZERLAND

From TINA to TARA



Quelle: Bloomberg, as at 29.09.2023.

While equity risk premiums in the eurozone and Switzerland are now roughly in line with the levels of recent years, they have fallen sharply in the USA since the interest-rate reversal and are now at their lowest level since 2006. This means that bonds have indeed become an acceptable alternative for investments in the USA. However, it is not yet clear that one should completely avoid US stocks. It is possible that corporate earnings in the future could exceed analyst expectations due to innovations in areas such as artificial intelligence. Further, it is conceivable that longer-term bonds, as seen in 2021 and 2022, might incur significant losses again due to interest rate increases – say, to combat unexpectedly persistent inflation. The latter, in particular, is a significant reason why we remain cautious about investments in longer-term bonds. To sum up, a low equity risk premium does not necessarily mean that one is in or on the verge of a bubble. It is, much like an inverted yield curve, simply an indicator of "weird" conditions.

Not a machine

For long-term investors with a high risk appetite, it seems clear that despite the currently uncertain situation, equities are essential in liquid investments – and in the long run it hardly matters when exactly one enters the market. According to a 2023 study by Credit Suisse, stocks in the USA have averaged an annual return of 6.4% since 1900 in real terms, i.e. adjusted for inflation. In contrast, bonds generated a return of only 1.7%, and cash a mere 0.4%. The figures are similar in other countries, and the pattern is valid for shorter time periods as well. In fact, since 2003, holding cash has eroded purchasing power everywhere. Thus, liquidity and bonds have been highly unattractive since the financial crisis due to zero and negative interest rates. The return of alternatives to stocks is especially welcome for those who due to, say, shorter investment horizons, have lower risk tolerance or find it challenging to cope with market fluctuations.

Now, what about the "economic machine" mentioned earlier? Unfortunately, the image with two big levers – interest rates and budgets – is deceptive. In general, the economy does not operate according to a mathematically predictable tableau, as attractive as that picture may be. Those who have bet on such a model have often failed spectacularly. One of the most famous examples is the debacle of the hedge fund LTCM, which had two Nobel laureates in economics on its team. Its 1998 rescue orchestrated by the US Federal Reserve just marked its 25th anniversary. Psychology, chance, and external factors are relevant, and experience and intuition play a role in navigating financial markets.

Inverse yield curves and decreasing equity risk premiums in the USA signal extraordinary circumstances. And Ray Dalio recently released a new book, along with another illustrative explanatory video, titled "The Changing World Order". Navigation remains challenging, but at least there are alternatives.

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IA, 30.09.2023

THE JOURNEY CONTINUES

Which developments of recent years will leave their mark on the history of the 21st century? On the global stage, undoubtedly the stagnation, and perhaps even the demise, of globalisation. In the realm of financial markets and economic events, it will be the end of the prolonged descent of interest rates below zero and the resurgence of long-forgotten inflation.

Both of these phenomena can be traced to the same origin. Without the supply disruptions caused by the Covid-19 pandemic and the war in Ukraine, inflation might have been delayed further. The open floodgates of money during the pandemic led to excess demand on the consumption side, which could not be met on the supply side due to ships waiting in harbours and goods containers piling up. Inflation always has a real and a monetary backdrop.

We have not reached the end of the line in terms of productivity gains. Innovations will usher in the next wave of globalisation. And this one will also have a deflationary impact.

How did we previously get so comfortable with the idea that practically everything would continually become cheaper and better? Because for over 40 years, a technological surge had effectively transformed the entire world, and because China's entry into the global economy had ensured low-cost labour for many years.

What's next? Have we reached the end of the line in terms of productivity gains, and will the return to mercantilistic selfishness sound the death knell for globalisation? Many currently believe so. I dare to doubt it. Here two relevant observations:

First, a visit to Huber+Suhner's factory in Herisau. We tour the production of fibre-optic cables. These are countless intertwined, ultra-thin threads that are protected against mechanical external forces and excessive bending and serve data transmission. Without such cables, the previous era of globalisation would have been inconceivable. Cables from Herisau, Switzerland traverse all the oceans of the world. A staff member casually mentions that future threads will be hollow, and data will be transmitted through them using laser light through the vacuum. Result: acceleration of the process to the speed of light, unhindered by the material of glass. Almost as it would be in outer space.

Second, an article in the Frankfurter Allgemeine Zeitung (FAZ) about quantum computers. A German-Finnish startup called IQM Quantum is apparently working on building an affordable quantum computer the size of a PC. It has the potential to multiply current computing capacities several times over – and this for general use!

These two innovations, interconnected, will usher in the next wave of globalisation. Namely because there will no longer be any reason not to perform any task decentrally. The next wave of globalisation will also have a deflationary impact. Efficiency will spread across a truly interconnected world like quicksilver. The journey continues.

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KH, 30.09.2023