Private Client Letter

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Precarious dynamics

In uncertain times, small changes can have huge consequences. Nevertheless, markets are currently upbeat. Investors with resources and strong nerves can continue to exploit opportunities – those without should reconsider the risks.

"El Niño" – this is the name of the age-old marine phenomenon that occurs intermittently around Christmas time near the South American equator. It manifests as a sudden warming of the Pacific Ocean and an absence of schools of fish off the coast of Peru. The phenomenon affects weather patterns stretching from America to Africa and Southeast Asia. Some regions become drier and hotter, while others become wetter and colder. The risk of droughts and floods increases; at the same time, some areas benefit from the change in conditions. Overall, the situation becomes more unstable, and predicting the weather becomes more difficult. According to recent reports, "El Niño" is now exceptionally strong, prompting talk of an extreme year.

Fundamental shifts in the Niño phenomenon, as well as the melting of the Greenland ice sheet and a handful of other events, are potential tipping points in the global climate system. Research suggests that in such a constellation of elements, small changes can have huge consequences. If a so-called tipping point is crossed, changes can be abrupt and, in some cases, irreversible. However, the exact thresholds for many tipping elements are uncertain or disputed.

In economics, too, researchers and analysts are constantly on the lookout for tipping points. One good example is sovereign debt. Under the title "This Time is Different: Eight Centuries of Financial Folly", economists Carmen M. Reinhart and Kenneth S. Rogoff noted in 2009 that negative consequences can be expected when a country's debt rises to 90 percent of gross domestic product. Nevertheless, in many countries, not least leading economic powers such as the USA and Japan, debt has clearly exceeded this threshold, in some cases for many years, without serious consequences. High debt levels must still be considered one of the greatest concerns and risks for the economy and society, even though the exact tipping point obviously cannot be pinpointed.

Unstable times

In the countless publications released at the turn of the year, there is often talk of fundamental change. One example is UBS's insightful outlook "Year Ahead 2024: A new world". According to the report, this new world will be defined by economic uncertainty, geopolitical instability, and profound technological change. Analogous to tipping elements in climatology, "Five Ds" are said to define our time: debt, deglobalisation, demographics, digitalisation, and decarbonisation.

Even if much of the year-end attention-seeking is hyperbolic, the times have been – or at least felt – particularly uncertain since 2020, if not earlier.

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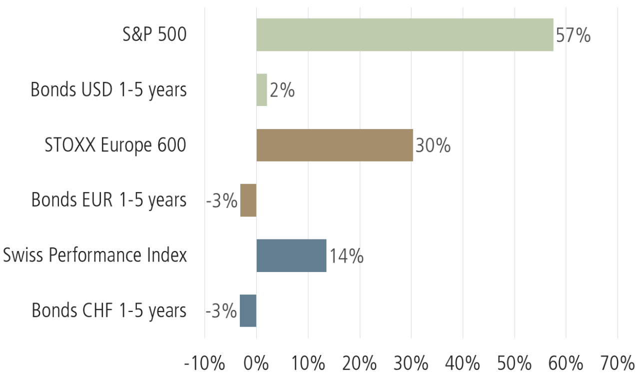
Whether the pandemic will eventually be viewed as a historical tipping point remains to be seen. What is clear, however, is that in the four years since the outbreak of Covid-19, financial markets have witnessed sharp downturns and strong upswings in quick succession. The year 2022, in particular, went down in history as one of the worst financial years in over a century. However, those who kept their nerve through the turbulence were rewarded in 2023, especially since stock markets in most industrialised countries made significant gains. As our chart shows, a certain boldness in equity investments has paid off since 2020. On the other hand, bond yields in Europe and Switzerland are already negative in nominal terms, and in the USA, this is also true after adjusting for inflation.

PERFORMANCE SINCE JANUARY 2020

COURAGE REWARDED



Source: For bonds, the aggregated Bloomberg indices (1-5y, Total Return) were used. For all indices, cumulative performance in local currency, as at 31.12.2023.

However, the fundamental question arises as to whether we really live in such a "new world" after all. UBS rightly points out in its report that over the last 120 years, humanity has experienced two world wars, nine pandemics, hundreds of civil wars and regional conflicts, over 2,000 nuclear detonations, several revolutions in the world's largest countries, at least a dozen cases of hyperinflation, over 15 bear markets, more than 20 recessions, and almost 200 sovereign defaults or debt crises. Against this backdrop, the remarkable adaptability of people and businesses, especially in the years since the pandemic, is astonishing and provides grounds for hope, despite justified despair over wars and poverty.

Investors, too, can remain optimistic over the long term, notwithstanding the need for caution. According to a 2023 Credit Suisse study, equities in Switzerland have yielded a real annual return (after inflation) of 4.5% in local currency since 1900 (USA: 6.4%), bonds 2.0% (USA: 1.7%), and cash 0.7% (USA: 0.4%). Clearly, there have also been phases of major losses in various asset classes, and wealth in some parts of the world has been existentially threatened or actually lost. Nevertheless, the principle persists: those who wish to preserve and grow wealth must be invested – even in volatile times.

It's all about expectations

Just as weather patterns appear more volatile and extreme when atmospheric conditions are in disequilibrium, the volatility in financial markets is greater and even more unpredictable in an uncertain environment. Even in a world governed solely by physical laws, climate and weather models quickly reach their limits in unstable conditions. In financial markets, the added dimension of psychology, marked by rapid shifts between fear and greed, further complicates matters. It is not for nothing that observers often point out that markets are more often trading expectations about the future rather than the hard facts of the present.

These expectations have been significantly influenced in the past year and beyond by two key factors. First is the innovation surge in the field of artificial intelligence that has given wing to the imagination of a few major companies. Performance on the US and, consequently, global stock markets has been largely driven by seven big technology firms: Apple, Alphabet, Microsoft, Amazon, Meta, Tesla, and Nvidia – almost all active in the field of artificial intelligence. These companies are now referred to as the "Magnificent Seven" due to their overriding influence. The rapid ascent is evident in the fact that the

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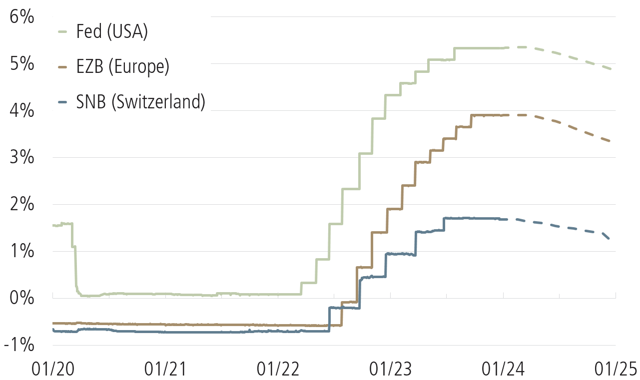
market capitalisation of these seven firms is equal to that of all companies in the MSCI United Kingdom, Switzerland, and Europe combined – ten years ago, the ratio was slightly over one to ten. The question now arises as to whether this dominance will persist or even increase. What is certain is that most of these companies are not excessively valued and, moreover, are profitable, unlike during the last major technology bubble in the early 2000s.

The second significant factor influencing financial market development continues to be the monetary policy of the US Federal Reserve (Fed). Similar to "El Niño", developments in the USA subsequently have a sizeable impact on the global economic climate.

CENTRAL BANK RATES SINCE JANUARY 2020

Pivot 2024?



Source: Bloomberg (Fed Federal Funds Effective Rate, ESTRON for Europe, SARON for Switzerland), including expectations as at 18.12.2023.

As our chart shows, a turning point in interest rate policy occurred in March 2022, first in the USA, later with other key central banks. This, referred to in jargon as the "Fed Pivot", was the main trigger for the market downturn in 2022. Expectations of an end to interest rate hikes then contributed to a recovery in early 2023. And as of late, markets are now hoping for a "Pivot 2024", this time in the direction of interest rate cuts. This has once again given a boost to the markets and lifted spirits at year's end.

Embracing risks and opportunities

"War, Euro, Migration, Debt, Inflation, Unrest, Geopolitics" – this is the subtitle of the new book by Swiss journalist Beat Kappeler. In it, he describes the challenges for our country and sheds light on the many unresolved problems of our time. In its outlook for 2024, "The Economist", on the other hand, recently highlighted the importance of the upcoming elections in the USA – noting that no annual outlook since its first appearance almost 40 years ago has been so dominated by a single individual. Consequently, a re-election of Donald Trump as president is depicted as the greatest danger to the world in 2024. Indeed, if the elections lead to an attack on US institutions, the world's current precarious balance could decisively topple.

Given the generally unstable environment and challenges on many fronts, the positive sentiment in the markets is rather surprising. As mentioned, this is based on eager expectations regarding innovation, a decline in inflation, and easing interest rates – should these not materialise, there is potential for major disappointment. In light of the risks and the currently somewhat more favourable market environment, investors should review their positioning at the beginning of the year. Perhaps the past few years have been a good lesson for the future: those who do not have the nerve or means to withstand major downturns should reduce their equity allocations and other risk positions. While the worst may be over for bonds and liquidity, it should be clear that negative surprises on inflation and interest rates could still generate painful losses.

On the other hand, those with nerves and resources should advisedly embrace risks (and thus opportunities). Experience shows that this usually pays off. And it teaches us that in times of great change and tipping points, things often turn out differently than expected. For 2024, this could possibly mean: better than feared.

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IA, 31.12.2023

Contemplating the worst...

...So that it never happens. Admittedly, it sounds a bit like witchcraft. Nonetheless, I have maintained this habit since childhood. Overall, I can say that luck has mostly remained faithful to me, as if I could ward off misfortune through its mental anticipation. It only became truly dangerous when overconfidence and carelessness gained the upper hand.

The turn of the year provides an opportunity to weed and plough through the garden of scenarios once again. Many things are familiar and must be left standing: national debt, higher interest rates, the sustainability of interest burdens, the decay of infrastructure, the loss of defence capability, the unwillingness of the younger generation to work, exaggerated expectations of the collective, and the recurring spectre of inflation – all admittedly terrible. But only relatively so.

A turn of the year provides an opportunity to weed and plough through the scenario garden once again. The worst case would be a gradual defeat of Ukraine in their stand against the Russian invaders.

The worst thing I can currently imagine is a gradual defeat of the Ukrainians in their stand against the Russian invaders and the termination of America's transatlantic defence of Europe after the next presidential election. What would this mean?

First, Europe would have to draw (even) closer together. Under external pressure, the ideas of subsidiarity and decentralisation would face even greater challenges than is currently the case. The need for rapid rearmament would seal the step toward fiscal union; the (high!) debt of most EU member countries would be definitively mutualised.

Second, in many European countries, the previously somewhat concealed pro-Russian forces on both the left and the right would put pressure on the moderates to move towards a policy of reconciliation with President Vladimir Putin. This option is already looming in the background due to the vital necessity of gas deliveries from Russia.

Third, Russia might be tempted to annex the Baltic states, as it did Crimea ten years ago, or to install an openly pro-Russia government in Serbia, which would have implications for other governments in European countries, especially those that are already less reliable.

Fourth, the mental and intellectual degeneration in Europe would have spread so far that decisions and actions in politics and economics would no longer be determined by the Western triad of Jerusalem (Christianity), Athens (Philosophy), and Rome (Law), but by an inexplicable inclination towards authoritarian systems and leaders.

Meanwhile, fifth, inflation and record-high interest rates would prevail, and the European economy would have definitively decoupled from the world economy.

The so-called unimaginable at the end of the year. In hopes that it never comes to pass.

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KH, 31.12.2023