PRIVATE CLIENT LETTER

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World of Contradictions

Political uncertainty and great fears of loss, tumultuous innovation and booming financial markets – we are living in times of upheaval. Investors must be ready for anything, but not everything is bleak.

"Seven Crashes" – under this title, the renowned economic historian Harold James analyses the world history of inflation and globalisation from 1850 to the present in his 2023 book. Against this backdrop, during a lecture in Zurich, James recently contextualised the current times, which many perceive as particularly dangerous. The key message of his presentation was summarized in a quote by Winston Churchill from 1936, where, in the face of growing uncertainty, he points out a general paradoxical oscillation between assumed omnipotence and visible impotence. The historian's message was that in 1936 it was a time of disorientation and contradictions, just as it is today. The obvious upheavals in the economy and politics unsettle people, and conversations are often marked by dark forebodings. The fall of the West, war, and chaos seem inevitable. At the same time, the actual way of life for large parts of the population in affluent Western societies does not yet seem fundamentally affected by all of this.

Is the situation better than the mood?

"They go on in strange paradox" – this also applies to the evident discrepancy between gloomy sentiments and the economic data in most Western economies. The long-forecast global recession is still nowhere in sight (we were already talking about "Waiting for Godot" in the summer of 2023), and respectable growth rates are still being recorded in many places, especially in the USA, where the economy is expected to grow by 2 to 2.5 percent in 2024. In many countries, unemployment is at historically low levels. Even in Germany, currently regarded as the sick man of the West, the jobless rate is just below 6 percent. Not least, inflation, the major concern of recent years, is now in the low single digits almost everywhere. Although it has not fallen below the magic 2 percent threshold anywhere except Switzerland, the (justified) concern about high inflation rates has largely subsided for now. The only economic warning signs come from survey-based Purchasing Managers' Indices (PMIs), which indicate declining economic activity in many Western industrialised nations. However, this has been the case for well over a year, without so far leading to a real downturn (with the notable exception of Germany).

Financial markets are not only a significant element of the economy; they also primarily reflect expectations for the future. In this context, the forecast interest rate developments play a key

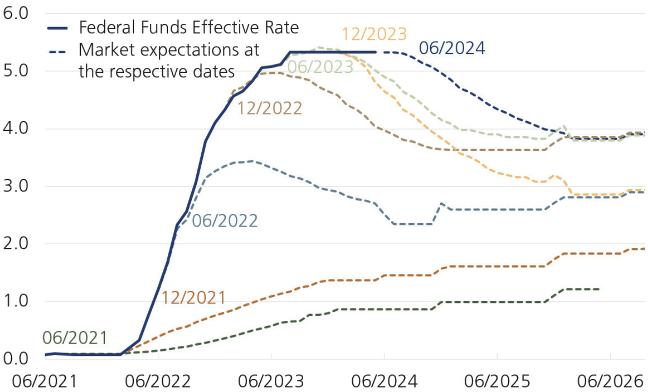
Private Client Bank AG
Alte Börse
Bleicherweg 5 – Postfach
8034 Zurich – Switzerland

T +41 44 253 73 00
F +41 44 253 73 20
info@privateclientbank.ch
privateclientbank.ch

role, particularly regarding the monetary policy of the world's leading central bank, the US Federal Reserve. As our chart shows, since the return of inflation in 2021, the markets have systematically and consistently underestimated the extent and duration of interest rate hikes in the USA. Fundamentally speaking, rising or persistently high interest rates are bad news for financial markets, as was particularly evident in 2022. However, at the latest since autumn 2023, the equity markets, at least, seem to have decoupled from interest rate expectations. So, here too is a paradox – interest rate cuts are being postponed, yet the markets are rising. The MSCI indices for the USA and Japan have been up by around 15 and 20 percent respectively (in local currency) since the beginning of 2024, Europe (MSCI EMU) and Switzerland (SLI) by 9 and 12 percent. Even the German DAX has gained over 8 percent.

INTEREST RATE EXPECTATIONS AND DEVELOPMENTS IN THE USA

SYSTEMATICALLY UNDERESTIMATED



Source: Bloomberg. US Federal Funds Effective Rate; 30 Day Federal Funds Futures Curves. 30.06.21-31.05.24.

Stock markets are booming despite disappointments on the interest rate front – and despite general uncertainty and geopolitical turmoil. The situation may indeed be better than the mood, at least for now. Today's interest rate levels are apparently not a problem as long as the economy is humming along and there are no waves of bankruptcies or sovereign debt crises. Given the high and rising debt levels in Europe and the USA, this poses a risk that should not be underestimated, and that could become a pressing issue sometime in the future.

All eyes on AI

It is hard to believe our eyes: amid great uncertainty and adverse interest rate developments, equity markets, especially in the USA, are climbing from one all-time high to the next. The mere absence of a recession is hardly a sufficient explanation. It may be a somewhat simplistic suggestion, but in hindsight, it is notable that a significant turning point for financial markets coincided with the introduction and spread of ChatGPT at the end of 2022. Since then, the surge of companies developing artificial intelligence (AI) and providing the corresponding infrastructure has been unstoppable – NVIDIA, Microsoft, Alphabet, Apple, Amazon, as well as ASML, SAP, and others have been the talk of the town. Those who have exited their investments in these companies, given the already substantial and generally increasing valuations, may feel frustration when looking at the current stock prices.

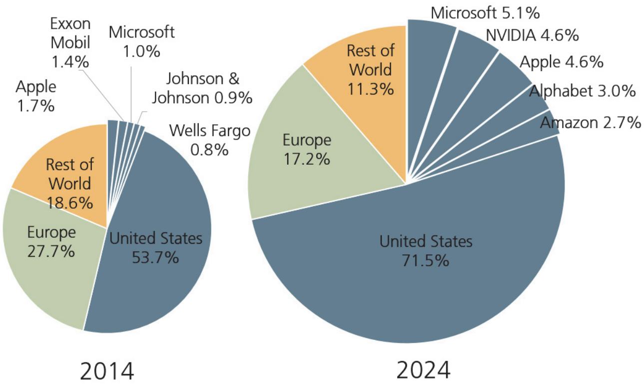
Can this continue? Economic historian Harold James presents an intriguing thesis: in his monumental study, he identifies seven major crises since 1850 that have fundamentally transformed the economic order and society. Thanks to the enormous adaptability of economic actors, many of these crises – with the significant exception of World War I followed by hyperinflation and the Great Depression – have triggered transformations with positive outcomes for people's prosperity. James cites, among others, the high inflation of the 1970s and the financial crisis of 2008. Economic shocks as learning moments with transformative character: that is the optimistic view of particularly uncertain times. This is especially true when sudden supply shortages occur and/or new technologies drastically change relative prices in a short period. Against this backdrop, James identifies the great lockdown of 2020–2021 as the latest transformative crisis whose effects we are witnessing today. In his view, the Covid shock favoured and significantly accelerated the development and adoption of new technologies in IT and AI. This could even, contrary to current fears of ongoing deglobalisation, trigger a new wave of globalisation and growth.

Private Client Bank AG
Alte Börse
Bleicherweg 5 – Postfach
8034 Zurich – Switzerland
T +41 44 253 73 00
F +41 44 253 73 20
info@privateclientbank.ch
privateclientbank.ch

The development of AI requires enormous effort and investment. It appears that the USA, as a large, open, and financially strong market, has a distinct advantage here. According to Stanford University, private AI investments in the USA amounted to USD 67.2 billion in 2023, with China a distant second at USD 7.8 billion, followed by the UK at USD 3.8 billion and Germany at USD 1.9 billion. The dominance of the USA is also evident in the markets. As our chart shows, American companies now make up nearly 72 percent of the Bloomberg global equity index, up from 54 percent in 2014. The major loser is Europe, whose share has shrunk from nearly 28 percent to 17 percent.

SHARES IN THE GLOBAL EQUITY MARKET 2014 AND 2024

US DOMINANCE, CONCENTRATED



Source: Bloomberg. Market capitalisation of the Bloomberg Developed Markets Large & Mid Cap Index on 24.06.2014 and 24.06.2024. The size of the circles roughly reflects the size ratio of market capitalisation (2014: USD 32.9 trillion, 2024: USD 65.3 trillion).

As in every technological revolution, the concentration on those firms at the forefront of change increases. Every week, we read headlines that IT giants from America are individually worth more than the entire Swiss or German stock market. So for the foreseeable future, the motto remains: “The winner takes it all,” with all its opportunities and risks.

The glass is half full

Tumultuous technological developments, a significant bull market, high political uncertainties, and pronounced fears of loss, especially in Europe – this is how the world stage is set before the major elections in France, the UK, and the USA. Is the glass half full or half empty in this paradoxical world? In Harold James' quite optimistic interpretation, we are in the midst of a historical shock, with good chances for a new, positive dynamic to emerge. Financial market participants have likely had the same interpretation for the past year and a half. For now, it seems it could indeed continue like this for quite a while longer.

Darker scenarios are also conceivable, but certainly not as compelling as often portrayed. However, there are still dangers: the high concentration on AI in the USA carries considerable potential for disappointment. Even more dangerous would be if the USA, shouldering high debt, suddenly encountered a loss of confidence and withdrawal of investors – notably, China is by far the largest creditor of the USA. Finally, in Europe, there are threats from the expansion of Russian aggression and other instabilities of all kinds.

In contradictory and uncertain times, investors must be prepared for anything. This primarily involves constantly assessing one's financial capabilities, obligations, and risk tolerance. It also means a smart diversification of investments across different asset classes. It is important to understand that equity investments should not only focus on leaders in AI but also comprise solid companies that may have fallen out of favour with investors – current examples include Swiss heavyweights Nestlé and Roche. Based on everything we know, this approach prepares us for both good and challenging times. And should the times indeed turn bleak despite our optimism, we can find solace in the closing thought of Harold James' book, that we learn the most when the present is darkest.

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IA, 30.06.2024

Property ownership under pressure

"Where Shall I Flee?" – this is the title of a chorale cantata by Johann Sebastian Bach, of which the author of these lines is known to be particularly fond. Baroque language sometimes conveys ideas more effectively than today's refined expressions. Having no refuge, becoming homeless, or, in the worst case, being persecuted: these are not life goals. However, this is what threatens those who have created wealth, manage it cautiously, invest successfully, and thus belong to "the rich".

There is a palpable animosity towards wealth and the wealthy. Why is this the case? Because, practically everywhere, public coffers have been not only emptied unnecessarily but also burdened with such high levels of debt that the future interest payments will deprive the treasuries of the world of any freedom of action. Additionally, the pension systems of demographically shrinking societies are often not correctly accounted for. There is thus a need for financing. Understandably, there are attempts to take money from where it supposedly lies, namely with the wealthy.

Most worrying is the erosion of property ownership as a pillar of the rule of law and a functioning civil society.

It is more than a rumour that the OECD is working on a broad campaign for global wealth taxation. They know that capital is mobile, and poorly coordinated initiatives will hardly generate additional tax revenue, but are more likely simply to benefit territories that are able to evade the Paris tax cartel (at least temporarily).

Another, harsher method of targeting the wealthy involves criminalising property ownership. This is usually justified by legitimate, noble causes such as fighting terrorism or drug cartels, or even preventing the cronies of bloodthirsty autocrats from enjoying the benefits of free capital markets. These concerns are valid and the fight necessary. However, it also produces severely discriminatory side effects. Entirely uninvolved and harmless individuals like you and me, can in this way be excluded, even expropriated. For example, not every wealthy Russian was or is a Putin sympathiser.

Most worrying, however, is the third type of access to wealth: the erosion of property ownership as a pillar of the rule of law and a functioning civil society. We have become so accustomed to countless restrictions, from building regulations to climate protection, that even classical legal doctrine today assumes an explicit "social obligation" of property ownership. But worse is to come: a popular initiative by the Swiss Young Socialists postulates a confiscatory inheritance tax of 50 percent on fortunes over CHF 50 million. The funds are to flow into the social security system (which also over here is heavily indebted); the taxation is to apply retroactively from the date of the popular vote. The move from subtle expropriation through restrictions to outright confiscation is accomplished, at least in thought.

"Where shall I flee?" In 2025, the UK will abolish the so-called "no-dom" status, hitherto a formidable refuge for wealthy foreigners from the world over. An exodus of thousands of affluent individuals is predicted. Dubai? Singapore? Hong Kong is already out.

Well, from my perspective, if you are affected, you can safely stay in Switzerland for now. After all, the immune response of the mostly level-headed Swiss voter is likely to be clear. However, in the longer term, and not only here but also in the rest of Europe, in London, in the USA, a return to the much-vaunted "Western values", to which property ownership unquestionably belongs, will be necessary. Otherwise, capitalism, which has been so beneficial to prosperity, is doomed.

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Private Client Bank AG
Alte Börse
Bleicherweg 5 – Postfach
8034 Zurich – Switzerland
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F +41 44 253 73 20
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