# Private Client Letter

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# Every single year

The annual round of forecasts and predictions has some entertainment value, but is of limited use. When it comes to investing, it is much more a matter of regularly reviewing your strategy while keeping a steady hand and a bit of courage.

"Tomorrow good weather" – the mountain guide cheerfully welcomes the expectant group of tourists from abroad. You cannot see your hand before your eyes, the spectacular Alpine panorama is hidden by thick clouds. It's spitting rain. The scene repeats itself for a few days until the skies actually clear and the horde of guests crammed into stuffy hotels can once again pour freely onto the ski slopes. This is just a minor scene from a series called "Every Single Year", which flickered across German TV screens in the 1970s: a parody of the ritual of the German annual winter vacation. A family goes on holiday full of expectations, from which a multitude of sobering experiences and, above all, an empty wallet remain at the end.

The investment community also has its annual ritual. In December and January, the forecasters are in full swing; projections for economic development, stock markets, interest rates and currencies for the coming year fill the shelves and media. They do exist, the bad weather forecasters, who point out with great regularity that it really is now five minutes before midnight and that the big economic and market crash is imminent. But the rule – at least for the stock markets – is those who predict higher prices. According to Bloomberg, the median of analyst expectations for the US equity index at year-end has been for higher prices every year since 2009, without exception. And indeed, the consensus was correct most of the time: since 2010, the S&P 500 has closed lower at the end than at the beginning of the year only twice – namely in 2015 and 2018. It is also noteworthy that forecasters' already optimistic expectations were exceeded in seven out of twelve years. In 2013 and 2021 the market was actually more than ten percent higher after twelve months than was expected at the beginning of January.

**Forecasts with limited reliability**

One of the macroeconomic variables that has been watched particularly closely in recent months is inflation. In addition to the unexpectedly strong appreciation of the US dollar against practically all currencies, the high inflation rates worldwide are probably one of the biggest surprises of 2021. Virtually no one had such an outbreak on their radar: as our chart shows, at the beginning of the year the highest inflation forecast of all analysts, according to Bloomberg, was 3.3 percent in the USA. This means that the expected actual inflation rate of around 7 percent for 2021 will be far outside all registered forecasts for the first time since 2010.

The reasons for rising inflation are now widely known and have also been discussed in detail in

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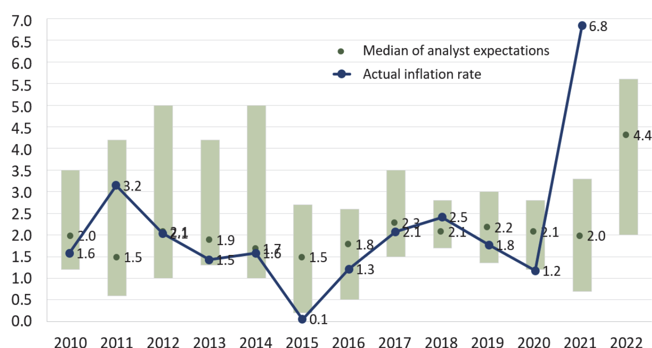
these pages in the past: pandemic-related disarray in supply chains, rising energy prices, statistical base effects and huge fiscal and monetary stimulus programmes. It is equally well known that the analyst consensus is for somewhat lower inflation rates in 2022, even if the range of forecasts is very wide – currently between 2 and 5.5 percent for the USA. There is no doubt that we are entering a phase of heightened uncertainty with regard to inflation, especially since, on the one hand, strong deflationary effects continue to be at work beneath the surface (globalisation, digitalisation), while on the other hand, inflationary factors are also gaining in significance (demographics, decarbonisation). Against this backdrop, the most obvious scenario for most countries seems to be somewhat lower inflation in 2022, but generally higher inflation rates than before the pandemic.

INFLATION IN THE USA, FORECASTS AND ACTUAL

THE BIG SURPRISE IN 2021




Source: Bloomberg forecasts at the beginning of each year (range in light green bars). The actual inflation rate for 2021 is the figure published in November, year-on-year.

On the whole, it can be seen that consensus forecasts on major economic aggregates such as inflation, growth or interest rates can be relied on above all when there is little uncertainty in the economic environment and the bandwidths are correspondingly narrow. In uncertain times – i.e. when they would actually be most useful – medium-term forecasts in particular quickly lose value and are constantly adjusted. At the beginning of 2021, for example, the forecasters did not expect a single interest rate hike in the USA for at least the next two years. After several revisions in recent months, there is now talk of three interest rate hikes in 2022. In any case, it is clear that when it comes to economic developments, we will have to proceed with somewhat greater caution for the time being.

**Focus on good companies**

If reliability is already limited for macroeconomic forecasts, how much more is this the case for price predictions for individual investment instruments. In general, this rule of thumb applies: the higher the risk of the instrument, the greater the fluctuation margin and the less reliable the forecasts, when they are given as a specific figure for a fixed date. Note that this also applies to the largest companies in the world, which are constantly observed and reviewed by legions of analysts.

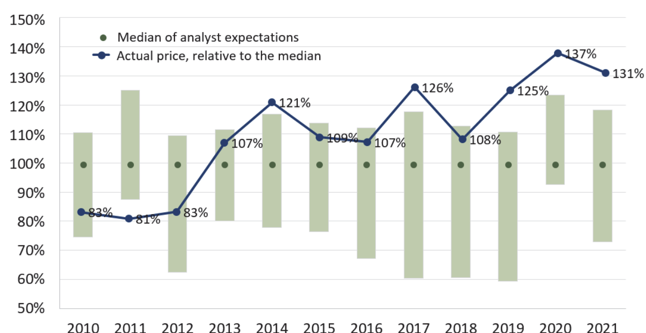
Against this backdrop, we examined analysts' share price forecasts since 2010 for Microsoft, one of the three largest companies in the world by market capitalisation. As our chart on the next page shows, the share price at the end of the year was outside the range of all 12-month forecasts in 50 percent of the cases. In 40 percent of the cases, the deviation was even greater than 20 percent of the median expected price at the end of the year. In fact, Microsoft has surprised on the upside since 2013. The share price has exceeded analysts' corresponding expectations every year, and in 2020 by as much as 37 percent. In short, it is possible that a throw of the dice would have yielded results that were about as meaningful as analysts' meticulously computed price targets.

In general, we believe that a forecast of share prices at a year's distance does not focus on the right thing. The world is too complex, the timing too difficult, the pace of change too unpredictable. However, this by no means suggests that a thorough analysis of a company is not worthwhile. On the contrary, investing in good companies is both a trade and an art. It involves understanding the market environment and industry, assessing the quality and competitiveness of the products, and examining the organisation, company culture

and finances. Only then is it possible to separate the wheat from the chaff. And those who invest in good companies will ultimately reap a reward.

MICROSOFT'S SHARE PRICE, FORECASTS AND ACTUAL

## Forecasts often missed




Source: Bloomberg. Example for the interpretation of the graph: At the beginning of 2010, the range of forecasts for Microsoft's share price in 12 months was between 10 percentage points above and 25 below the median. The actual price at the end of the year was 83 percent, 17 percentage points below the median.

In times of rising inflation rates, equity investments are often mentioned in addition to real estate and gold as instruments with good protection against rising prices. From our point of view, this is especially true for investments in companies that, due to a strong market position and good products, can raise their prices without much effort and at the same time also have good negotiating power with their suppliers. A high degree of flexibility and efficiency, motivated and highly qualified employees as well as broad diversification across suppliers and customers are factors that are important to us when selecting companies. Investments in such firms can be characterised as real value, and this is especially important in times of inflation and uncertainty. Naturally, a company's quality is also relevant when considering bond investments – even if fixed-income paper appears particularly unattractive now in times of low yields and the risk of rising interest rates.

**Courage and a steady hand pay off**

In the TV series described at the beginning of this article, the family man tries to save his increasingly disastrous holiday with hectic activity. Over and over he meets new salespeople who gladly make him a most attractive-looking offer. This inevitably ends in a fiasco.

If we are honest, we can usually gain only a limited amount from the annual round of "outlooks for the coming year", for all their entertainment value. Caution is called for because behind many of the loudly proclaimed predictions there are quite understandable sales intentions. After all, there is also a market for forecasts; the demand must be satisfied. When it comes to investments, though, a steady hand is often preferable to nervous activity. Against this backdrop, it is important to us not to sell investment funds on the latest fads or to encourage our clients to make transactions in our own interest – hence our preference for flat fees.

However, despite all restraint with regard to the annual forecasting ritual, it certainly makes sense to take stock of one's own financial situation and investment portfolio at regular intervals. Am I planning a major investment, has anything changed in terms of my risk tolerance? Could I continue to sleep well in the event of a major market correction? Is the portfolio still tailored to my profile? Would I need to rush into action in the event of setbacks? All these questions are more important than year-end forecasts.

"Tomorrow good weather" – that is the motto of our cheerful mountain guide. On closer consideration and despite all the uncertainty, this optimism does not seem to be the worst strategy for investors either. After all, confidence has nearly always paid off for long-term investors in the past – even if it sometimes calls for a bit of courage and patience.

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IA, 31.12.2021

# SYSTEMS COMPETITION PUT TO THE TEST

In theoretical terms, many, though not all, were of one mind: whether and under which circumstances a regime proves itself is best shown by letting competition play out. Thus the mercantilist economic system, devised by clever Frenchmen, succumbed in the long run to the Anglo-Saxon idea of free trade revolutionised by David Ricardo. And so the Western social market economy prevailed over the Eastern communist system.

The main question is: who will manage to exit crisis mode quickly and relatively unscathed?

This in turn does not mean that obsolete system ideas completely disappear. On the contrary, mercantilism is currently celebrating a revival in dealings with China, an increasingly important trading partner, and is now even being treated as a specific function of the European Union, which otherwise likes to present itself as a champion of liberal markets. And in collective solutions, which tend not to stray far from the old communist paths, many, especially intellectuals, see the way out of all kinds of problems, from climate change to the ageing of society to the question of income distribution.

Indeed, friends of systems competition should be rejoicing at the moment: rarely has there been such a pronounced constellation of simultaneity to observe. Yes, we are talking about the coronavirus pandemic. The disease broke out in virtually all countries around the world with little staggering. Obviously, authorities in democratic states struggled to react quickly and clearly. Despite repeatedly rehearsed pandemic scenarios, the countless interfaces of an open society proved to be quite a hindrance to efficient crisis management. No Western-style government excelled. In many cases, paralysis, chaos and overreaction prevailed. This is nothing to gloss over.

In contrast, China seemed to come out on top in dealing with the corona situation, as it did in many economic matters. The source of infection in Wuhan was quickly smothered, and economic performance picked up again after a month or two. However, this has come at a price: the country has been almost completely cut off from the outside world for almost two years. Those wishing to enter the country must accept a quarantine of three weeks and are literally treated like outcasts. With the Winter Olympics opening in China in a few weeks, the "laboratory arrangements" are definitely getting interesting. How will the Chinese state react to the inevitable infections of athletes, officials and visitors? Will its own population continue to be hermetically sealed off? Or will China, contrary to expectations and possibly very cleverly, allow the apparently less dangerous Omicron variant to spread in the country with the Games?

The counter-example to China was Sweden for some time, now it is Great Britain – another large-scale experimental arrangement. Sweden's corona policy has experienced considerable contrasts. In the UK, Boris Johnson initially took a particular type of skid control course, but now seems to be getting on track with high vaccination rates and a liberal contagion strategy. Meanwhile, the Dutch, Germans and Austrians are struggling with new restrictions on public and private life.

The main question is: who will manage to exit crisis mode quickly and relatively unscathed? There are systems and regimes whom the special situation suits quite well and for whom their own survival is more important than the welfare of the citizens. Thanks to the competition between systems, we will soon know more about this.

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