Private Client Letter

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Fear and Greed

The duration and degree of market aberrations cannot be predicted. Although the markets have already priced in a great deal of bad news, unpleasant surprises still loom. Investors should stay on their guard.

"We simply attempt to be fearful when others are greedy and to be greedy only when others are fearful" – this is undoubtedly one of the best known quotes from one of the most successful investors of the last 70 years, Warren Buffet. It was published in the investor letter of his company Berkshire Hathaway in February 1987. Those were days of accelerating inflation and market exuberance, which ended with an epic crash on 19 October 1987. The Dow Jones index in the USA lost 23 percent of its value on a single day, and it took nearly two years to recover from the collapse.

Some 20 years later, Buffet reiterated his motto on the American television station CNBC, emphasising that he had never seen so much fear in the economy as at the time of the interview. It was 1 October 2008, a peak of the 2007–2009 financial crisis. The US stock index S&P 500 had already shed nearly 25 percent of its value since October 2007. Yet even after the often-cited interview of 2008, the index slid another 40 percent or so until mid-March 2009. By that time, investors in the US market had lost considerably more than 50 percent of their capital from the previous high in autumn 2007 to the final low in spring 2009. Prices recovered swiftly thereafter, but did not regain the 2007 high until January 2013.

For investors, 2022 has been the worst year since 2008, and most likely the second-worst of the last 50 years. The Pictet reference index for pension funds (60 percent bonds, 40 percent equities), widely known in Switzerland, is down more than 16 percent since the beginning of the year. Bonds are losing ground because of the steep rise in interest rates, and equities have fallen sharply again for the same reason after a short recovery surge in July. The global equity index is down 25 percent in US dollars since the beginning of the year, while the US Nasdaq tech index has shed nearly 30 percent. Of the top 35 stock markets with global significance, only four are currently in positive territory. They include Turkey (+72 percent) and Argentina (+65 percent), which are reporting – remarkable detail – inflation rates of 80 per-cent and 79 percent, respectively. It seems that at least in these countries and with such high inflation rates, the inflation protection offered by equities is effective to some extent.

Widespread fear

The causes of the grim market developments are well known and have been discussed here previously. The focus of attention is on high inflation, initially triggered by supply chain problems and shortages as a result of the Covid-19 crisis, then

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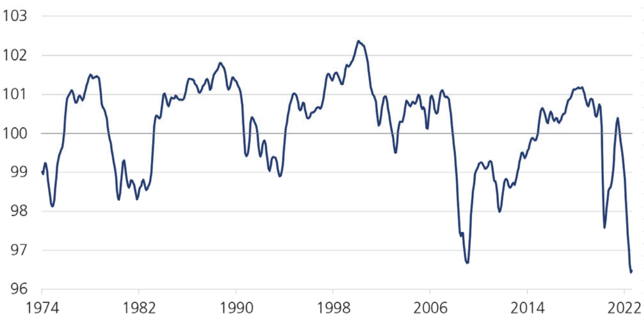
fuelled by a steep rise in energy prices in the wake of the war in Ukraine. Furthermore, the world is undergoing a process of deglobalisation initiated by geopolitical conflicts. And as if that were not enough, we are also facing the challenges of climate change and the onset of retirement of the "baby boomers" from the labour markets. The last three trends, in particular, have the potential to drive prices upward for a prolonged period. They confront an economy that has been swamped with liquidity for many years and already contains considerable inflationary potential. It is no coincidence that the German asset manager Flossbach von Storch AG published its report from last July under the headline "Crisis Cocktail", noting that there has rarely been a phase in history with so many simultaneous crises.

CONSUMER CONFIDENCE SINCE JANUARY 1974

Maximum Pessimism?



Source: OECD. Values over 100 indicate positive consumer attitude towards the economy and business activity; values below 100 indicate negative expectations.

For some time now, fears of a recession have also been weighing on sentiment. This is due on the one hand to the central banks, which have clearly indicated that they would probably accept a recession in order to stifle rampant inflation if necessary. On the other hand, it is increasingly evident that China is not only suffering from the failed zero-tolerance policy on Covid-19. Rather, a full-blown real estate crisis has also been eating through the country's economy since autumn 2021. Considering that around 70 percent of private wealth in China is invested in real estate, and that many of the flats that have already been paid for will probably never be built, it is not shocking that consumer confidence in China has also fallen to long-term lows. It is probably no exaggeration to say that a previously reliable engine of the global economy is currently experiencing severe problems.

Against this backdrop, it is not surprising that widespread pessimism about the future of politics, the economy and the financial markets is the order of the day. Notably, volatility indices – traditional tools for measuring uncertainty – have been registering heightened values for some time, although the huge swings of panic and sell-offs have yet to occur. Other indicators, however, are at historical lows, such as the OECD consumer sentiment indicator pictured in our chart. According to this, sentiment is lower now than at any time since 1974, undercutting the lows during both the financial crisis and the pandemic.

Positive and negative surprises

With the quote from Warren Buffet in mind, the question arises whether the trend has bottomed out and whether, given the widespread fear, the time has come to be "greedy". The financial markets are known to be leading indicators for future economic developments; turning points are identifiable here earlier than elsewhere. Is the pessimism so deep that all the bad news is already factored into asset prices? Is the probability of positive surprises already greater than for negative ones?

Of course, geopolitical developments, notably in Ukraine and especially Taiwan, are difficult to predict, and may surprise on either side. And as for the energy supply, the media is full of warnings of shortages and catastrophic scenarios. While this should certainly be taken seriously, it is also true that catastrophes rarely turn out to be as disastrous as the media and public expect. Basically – and this applies equally to supply chain problems of all kinds – the enormous adaptability of companies and consumers in a market economy is often

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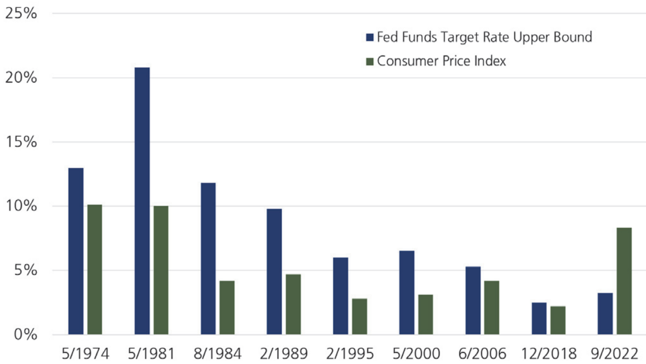
underestimated. Admittedly, the condition here is that prices be allowed to fulfil their steering function, which unfortunately is increasingly impaired by heavy-handed political interventions. Nonetheless, there could be positive surprises here, as we observed in many places during the first phase of the corona crisis.

INFLATION AND PEAKS IN BENCHMARK INTEREST RATES (USA)

STILL A LONG WAY TO GO



Note: Fed Funds Target Rate Upper Bound & CPI YOY at the end of prior tightening cycles.

We still face the key question of inflation and interest rates. This is probably the most important difference to all the major crises of the last 30 years: in inflationary times, central banks can no longer counter problems in the economy with injections of liquidity. And in our view, it is quite possible that many actors, including those in central banks, underestimate the persistence of the current inflationary trend – deglobalisation, decarbonisation and the demographic shift are, as already mentioned, new phenomena that tend to drive prices.

The sharp market corrections this year were triggered to a large extent by the US Federal Reserve's surprising resolve on raising interest rates. Since 1987, the Fed has not lifted interest rates as rapidly as in 2022. And history teaches that interest-hiking cycles have only ever ended when benchmark rates have risen above the inflation rate, usually significantly (see chart). So unless inflation falls considerably in the coming months, or the US Fed loses its nerve, there must be more interest rate increases ahead than the markets currently expect. That would still be a long way off and, apart from a war in Taiwan, the potentially biggest negative surprises lurk here.

Stay on guard

Fear and greed are two highly contagious diseases that will occasionally break out in the investment community, although it is impossible to forecast when and how they will strike. Equally unpredictable are the duration and degree of the market aberrations they produce, according to Warren Buffet's 1987 investor letter cited earlier. And further: "Therefore, we never try to anticipate the arrival or departure of either disease."

We do not want to try either, even if, after weighing all the factors discussed here, it may seem that the bottom has not yet been reached and that one or two negative surprises could still be waiting for us. Accordingly, we have been acting with more caution for about half a year and for the time being are not buying up to the strategic equity quota in the portfolios we manage. However, this by no means suggests that we think investors should say farewell to "riskier" investments such as shares. If positive surprises or very high inflation were ahead, this could be precisely the wrong step.

In general, it would be very bold to manage assets as if one knew what the future would bring. The compass for the correct investment policy must always be the question of whether assets should be invested for the long term, and whether one can sleep well during fluctuations. And above all else, whether short- or medium-term obligations exist that one might not be able to meet. Everything else is a craft that should be exercised with a generous dose of modesty – in times of greed and also in times of fear.

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IA, 30.09.2022

UNRESOLVED SUCCESSION PROBLEMS

"What is the main difference between democratically governed states and autocracies?" The question was posed to me by former NZZ correspondent and astute observer Urs Schöttli at one of our regular meetings where we discuss the world situation. I listed the usual things. Participation of the people, sharing of power, control over the elites. "Yes, of course. But I was asking about essentials." Our analytical exchanges tend to be quite merciless in intellectual terms.

We know from managing private assets and advising families on inheritance and succession issues, among other things, how difficult the replacement of a generation can turn out to be. After all, nothing requires more getting used to than the loss of power.

"Democracies, unlike autocratically ruled countries, have the succession problem under control. Fifty percent plus one vote, that's it." What we see in Russia, but also in China, can be reduced to an unresolved succession problem. Consider Vladimir Putin, for 30 years at the top of an increasingly corrupt, mafia-like pyramid of power in the form of an outwardly state-like entity. Tending to exaggerate his importance in Russian history. Surrounded by vassals who are loyal until signs of weakness make it advisable to bring accumulated spoils into a safe place – which is why Ukraine's emerging victory threatens to become so dangerous. Then Xi Jinping, who like his predecessors should have resigned from the Central Committee of the Chinese Communist Party after two terms in office, but now wants to continue governing for the foreseeable future because otherwise China could allegedly break apart. A ruler to whom there seems to be no alternative but who, with his zero-Covid strategy, has now manoeuvred himself into an economic and socio-political *cul de sac* from which it is difficult to break out or turn back. Xi would like to become greater than Mao Zedong or Deng Xiaoping. Taiwan, a yardstick for imperial completion, is therefore of immense importance, even though coexistence so far has been enormously beneficial for both sides.

We know from managing private assets and advising families on inheritance and succession issues, among other things, how difficult the replacement of a generation can turn out to be. After all, nothing requires more getting used to than the loss of power. But spin it any way you please: any human is mortal. Any behaviour or structure that amounts to disregarding this fact or depriving it of its inevitable poignancy is foolish. In the case of economic empires, there is the threat of total loss in the end, but in the case of political power, it can quickly come to human lives and geopolitical security.

Sometimes one could wish that there was, somewhere in the world, far away in the southernmost Pacific, a beautiful isle where one could dispose of worn-out autocrats. And yes, they could live there in luxury, at the expense of the global public, for all I care. But one thing they could never do: return to power!

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KH, 30.09.2022

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