Private Client Letter

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Winds of Change

With the interest rate reversal, every single asset is being revalued. This is painful, especially in conservative asset classes such as bonds. Furthermore, the effects of rising interest rates have not yet been processed everywhere.

"The big question on everybody's lips: Whither are we drifting?» – with these words, Florian Illies addresses the uncertainty on the eve of the First World War in his international bestseller «1913: The Year before the Storm», published ten years ago. Today, with the privilege of hindsight, we imagine this must have occupied people's thoughts constantly. But Illies brilliantly sketches out that time with anecdotes and everyday stories that have nothing to do with the looming war, certainly not explicitly. The phrase directly preceding the big question quoted above is representative of this: «And Rainer Maria Rilke has the sniffles.» There is no answer to the question itself, the page remains blank – the protagonists cannot yet know where they are drifting. References to the forerunners of the great war and possible parallels to today thus play out primarily in our heads.

Given the cocktail of crises today – war in Ukraine, heightening tensions between China and the USA, climate change, deglobalisation, energy uncertainty, pandemic, rampant inflation, fears regarding interest rates and recession – the question of where we are drifting is once again cropping up in many conversations these days. The concept of a *Zeitenwende* – a watershed moment or epochal turn – has been fluttering through the news media at least since German Chancellor Olaf Scholz's speech to the Bundestag on 27 February 2022. It is in tune with the spirit of the age, as *Zeitenwende* was recently declared German Word of the Year for 2022, even if it is beginning to sound a bit hackneyed.

Indeed, we have several turbulent years behind us: 2020 pandemic, 2021 vibrant recovery, 2022 war and inflation. Despite all the rightful concerns, we would like to emphasise here at the start that the current cocktail of crises must not necessarily lead to a world war or the like. First, there have often been declarations of *Zeitenwenden* that later turned out not to be so, and second, not every *Zeitenwende* is synonymous with world war and destruction.

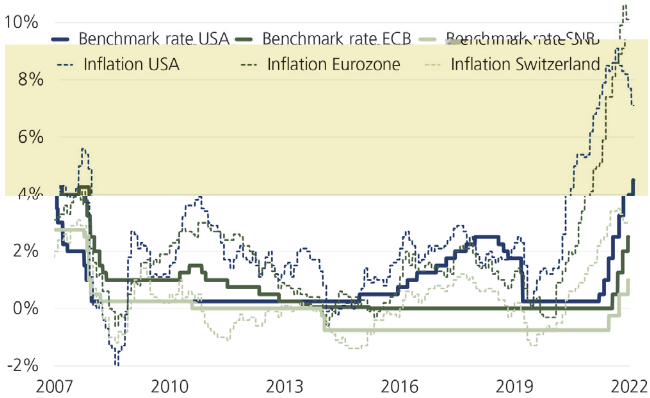
At the risk of not giving due credit to the «big question» and succumbing to the widespread habit of narrowing one's view to individual topics (or the so-called «single risk obsession»), we will focus in the following on what, in our view, is primarily responsible for the valuation corrections on the markets in the past year: the rise in the price of money. We are also doing this because we believe that this situation is indeed an easily measurable paradigm shift.

Interest rate reversal with consequences

In July, we pointed out that central banks around the world had begun to lift interest rates in the face of raging inflation. This trend accelerated in the second half of the year, so that interest rates have now been raised, in some cases dramatically, in all major economies except Japan, China and the special case of Russia. The chart below shows examples of the trend in the USA, the Eurozone and Switzerland. This brings to a close not only a nearly 15-year period of the lowest possible interest rates, but perhaps also a 40-year trend of falling interest rates. The path of inflation in the near future will be decisive.

BENCHMARK RATES AND INFLATION 2007-2022

NO MORE LA LA LAND



Source: Bloomberg, data for December 2007 – December 2022.

This development is surprising for market participants, who until recently had counted on ongoing cheap money policies – what we described a few years ago as «La La Land». At the beginning of 2022, the consensus forecast reported by Bloomberg was still calling for a US Federal Reserve benchmark rate of 0.9% in January 2023. In reality, this rate is now above 4.5% and thus more than five times higher than expected no more than a year ago. Similarly, the forecast for the Eurozone and Switzerland assumed a continuation of the negative interest rate regime until well into 2023 – here too, reality gives the lie to this notion, although the interest rate increases have started (too) late and timidly, especially in the Eurozone.

Interest rates, as the price of money, are probably the most important prices of all, since ultimately all prices in the economy are tied to them. A change in the interest rate means that all assets in the economy must be revalued. The significance becomes obvious with the aid of a simple example: if you invest 92 francs (or dollars) at an interest rate of 0.9% at a bank or elsewhere, then after ten years you will get 100 francs. Conversely, those 100 francs from 2033 are worth 92 francs today. If we now apply an interest rate of 4.5% to the same calculation, then the 100 francs from 2033 are now worth just slightly less than 65 francs, that is, around 30% less. Since in most cases it is impossible to say how high annual interest rates or yields will be over the longer term, financial markets are constantly occupied with measuring the current value of all kinds of assets on the basis of the latest information. Incidentally, it is the expected returns after deduction of (expected) inflation – i.e. the expected real returns – that are relevant for this valuation.

Against the backdrop of our simple example, it becomes clear why in a world with falling interest rates and low inflation all assets fundamentally increase in value. It is also clear that in a world of rising interest rates, the reverse is true and that, furthermore, great uncertainty about the future development of interest rates and inflation must be accompanied by sizable fluctuations in the valuation of all assets.

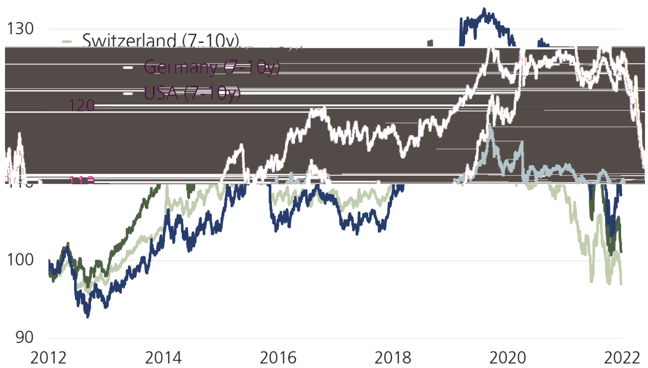
Absolutely everything is being reassessed

The revaluation of assets becomes immediately visible where they are constantly traded in large volumes – for example on liquid stock exchanges where marketable bonds, shares or currencies are traded. These react to new information on interest rates and inflation within milliseconds, often on the basis of algorithms and automated trading systems. Individual market participants who want to react to the same information – say, an interest rate increase or new inflation figures – will almost certainly be too late.

On balance, 2022 brought losses, in some cases dramatic, in almost every asset class. The increase in the price of money has caused a particularly painful effect on bonds, generally considered a conservative asset class – the longer the maturities, the greater the losses. There are few years in history in which bonds have performed worse than 2022. As our chart illustrates, the performance of Swiss and German government bonds over the last ten years has been either zero or negative – and this is after interest rates and before inflation.

PERFORMANCE OF GOVERNMENT BONDS 2012-2022

Painful 2022



Sources: Bloomberg US Govt. 10 Year Term Index TR, Germany Govt. 7-10 Year TR and Swiss Bond Index SBI Domestic Govt. 7-10 TR. Performance in local currency, December 2012 – December 2022.

But investors should make no mistake: even where valuation corrections are not immediately visible, they are very likely to take place, albeit with a time lag. The actual value of an asset only becomes evident when it is traded. For example, property prices are beginning to fall in many countries, including the USA, the UK and Germany. Even in private markets, which have been booming for years, there are increasing signs that in many cases valuations no longer correspond to what is on the books. The situation is especially precarious when it involves large amounts of debt. The moment of truth arrives at the latest when contracts with fixed interest rates expire. In other words, semi-liquid or illiquid assets offer no protection against revaluation – it simply happens in slow motion or not until sold or redeemed. At the same time, it is true that the effects of rising interest rates work through the economy very slowly and we have certainly not yet seen all the consequences of the interest rate reversal.

Painful, but hopefully healing

A scientific study of equity performance under the effects of inflation since 1940 (Neville, et. al., 2021) concludes that, on average, all sectors except energy sustain losses. Yet in four of the eight inflationary phases studied, even the energy sector experienced losses of 10–20%. In the case of 2022, only commodity and defence stocks truly gained ground – both sectors that were recently banned from most portfolios for reasons of sustainability and ethics. All other sectors suffered considerable losses, not least the technology sector, which until recently was one of the big winners.

Market participants will remember 2022 as the year there was nowhere to hide. Certainly, much of the bad news is already priced into the markets. However, the consensus seems to expect inflation to drop significantly in 2023, indicating that interest rates have peaked. If this is not the case, we would be facing unpleasant times again this year. Hence, we remain cautious, even though by now quite some of the correction is surely behind us.

Early in the 1990s, the German rock poet Udo Lindenberg and his «Panic Orchestra» embarked on their «*Wendezeiten*» – or: «Winds of Change» – tour. Whoever thinks back to those times today remembers feelings of openness and awakening. What we tend to forget is that geopolitically, it was a time of great uncertainty. War as a result of the disintegration of the Soviet Union was anything but unlikely; it actually broke out in Yugoslavia. Many countries of Europe experienced hyperinflation and recession. These adjustments were necessary to reduce distortions built up over decades. *Zeitenwenden* must not necessarily be catastrophic. The end of the irresponsible policy of cheap money is overdue and welcome, at least from an economic point of view. It is possible that 2022 saw the beginning of the end of this era. This is painful, but hopefully healing – ultimately for investors as well.

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IA, 31.12.2022

Special Skills Required

The inflation issue is not going away any time soon. This realisation has now reached the general public, and people everywhere are becoming accustomed to having to pay a little more here and there and everywhere.
What sounds so harmless is anything but when regarded in the clear light of day. Inflation is one of the worst economic and social evils imaginable. Because said general public becomes poorer in real terms in this process, and eventually some will be unable to maintain their accustomed lifestyle. Namely pensioners, who are hardly able to earn a few extra francs, euros or dollars, will soon find themselves with their backs to the wall.

The debt level is as high as if we had to cope simultaneously with a global economic crisis, a world war and a tsunami hitting all the seas. If even more difficult times are ahead, there are zero reserves.

There is no need to philosophise at length about the causes of the inflationary surge. Essentially, it is due to a completely irresponsible and excessive spending policy by the Treasuries of this world. The central banks supported this recklessness with floods of liquidity, in order to support the financing of ever higher debt. Along the way, the private sector was likewise encouraged to take on greater debt by the extremely low, at times negative, interest rates. As a result, the debt level is as high as if we had to cope simultaneously with a global economic crisis, a world war and a tsunami hitting all the seas. If even more difficult times are ahead, there are zero reserves.

In the near future, very specific skills will be required to overcome the unfortunate situation, or indeed to bring about an improvement in conditions. Whoever leads a ministry of finance in the future must be able to do a hundred times more than the predecessor in office, who could essentially act as an expenditure manager. Maintaining the highest credit ratings for borrowers such as Switzerland or the Federal Republic of Germany will be the gauge of whether or not such specific capabilities exist and take effect. England has recently had its first experience of the verdict of the reawakened financial markets.

Special skills are also in demand at private companies. Inflation accounting was last practiced in the 1980s; the experience of those days is gone. Corporate CFOs will first have to relearn what it means to manage working capital that is exposed to ongoing fluctuations in prices, and CEOs will need great strength to push through necessary price increases at the front. There will be companies that are more successful at this, and those that constantly lag behind the trend. It will thus be interesting for equity investors to differentiate between the black, grey and white sheep. In inflationary times, leadership is required; accordingly, intellectually based financial analysis must adapt to this.

Let us be clear: the long years of easy money made us lazy. The fact that this is over for the time being may be of some comfort to the fundamentally-minded.

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KH, 31.12.2022