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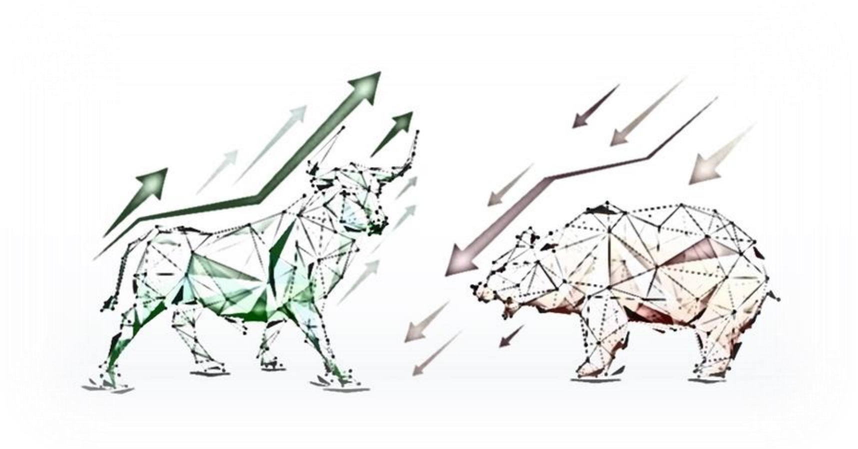


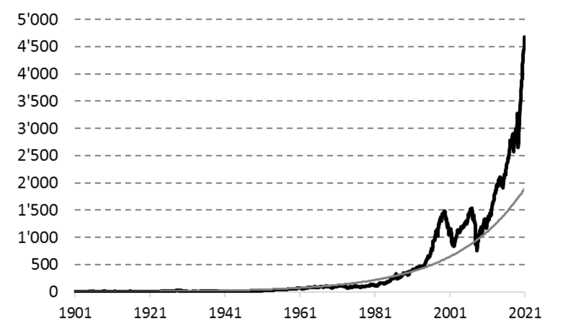
Zurich, February 11, 2022

IC No. 27 – Beauty and the Beast

The stock markets of the last few years can be summarised quickly. Cheap money, low interest rates, companies with record profits, no alternative to shares and, when in doubt, the central banks intervene. The result is an impressive price development over the last decades, exemplified by the US stock markets.

The Beauty

US equity market (black); exponential trend line (grey)



Source: Prio Partners, Financial database

In the corridors of the banks around the Paradeplatz, the topic of valuation levels is whispered about from time to time. But high valuation levels are quite understandable when interest rates are low or negative. So nice, so good. Nothing new.

Regime change?

After a long time, we are now potentially witnessing a regime change.

«Inflation was desired for a long time, but it was not there. Now it is there, but no longer desired.»

With the 7.5% inflation rate announced in the US on 10 February (the highest level since 1982), the pressure on central banks to act has increased significantly. If they do not raise interest rates, they make themselves untrustworthy. If they do raise rates, the question is to what extent this is acceptable.

The Beast

Inflation, development consumer goods prices compared to previous year (USA)

Source: Prio Partners, Financial database

It is at least questionable whether it makes sense for central banks to fight inflation, which is driven more by food and energy prices and supply chain bottlenecks, by raising interest rates. Historically, this weakens the economy, which may not be as strong as one might think.[1] Moreover, it will be interesting to see whether central banks can raise interest rates significantly at all in the face of high sovereign debt levels.

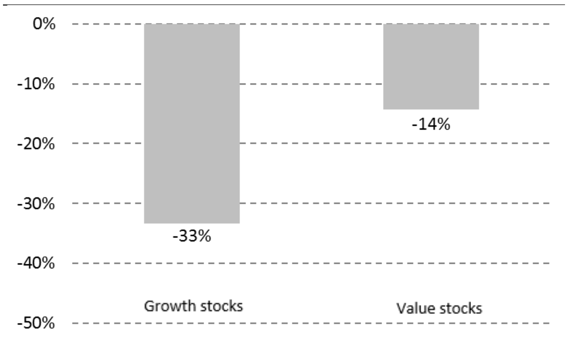
The announced interest rates hikes by the US Federal Reserve (but also by the European Central Bank) have made the markets sit up and take notice. We have taken this as an opportunity to show the influence of rising interest

[1] The US economy grew strongly at 6.9% in Q4 2021, with 71% of this growth coming from inventory accumulation. Real demand was much lower at around 2%. Source: https://economics.td.com/us-real-gdp

rates on company valuations with a simple sensitivity analysis. As expected, it turns out that growth stocks are particularly affected by rising interest rates, as their cash flows and profits lie far in the future - i.e. they are more heavily discounted. Accordingly, the price losses are particularly painful here: an interest rate increase of +1% leads to a price loss of around -30%. Interest rate increases also affect the valuation level of large, established companies, but the adjustments are not nearly as painful.

Painful reassessment

Interest rate sensitivity of company valuations to a +1% increase in interest rates, growth vs. value stocks

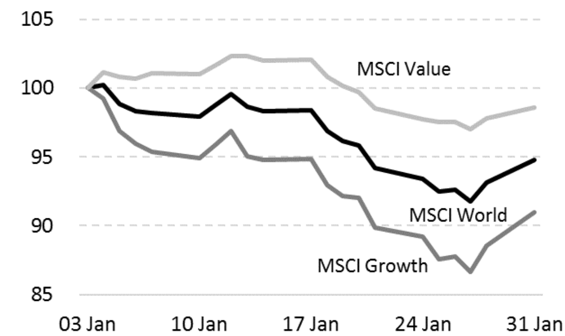


Source: Prio Partners

The described process of price discovery when interest rates are rising started on the market some time ago, but has come to the fore even more with the concrete announcement of interest rate hikes by the US Federal Reserve. January 2022 was accordingly volatile and had a negative impact on the equity markets. The valuation losses described above were also reflected in the market development.

Marktentwicklung seit Jahresanfang (indexiert)

Vergleich Wachstums (Growth)- vs. Substanztitel (Value)



Source: Prio Partners, Financial database

Small and medium-sized growth and technology stocks in particular lost ground (shown with the MSCI Growth). The so-called value stocks (e.g. large industrials, insurance companies) held up better (shown with the MSCI Value).

Positioning

Now, where do we go from here and how do we position ourselves in this environment? We significantly reduced our allocation to small and mid-caps as well as peripheral tech stocks last summer and are continuing to do so.[2] We recommended and implemented the rebalancing of our portfolios from growth stocks to more defensive value stocks in December 2021.[3] In this respect, we are convinced that quality stocks with high margins have an easier time passing on cost pressures to their customers or are better able to deal with cost pressures.

In general, we remain convinced that the market environment is currently less favourable for overweighted risk positions. We recommend waiting for the first interest rate hikes by the US Federal Reserve in order to better assess the reaction of market participants.

In addition to these overarching questions on portfolio allocation, we find two topics quite interesting.

1. The so-called «reopening trade»: in other words, buying companies that benefit from the revival of the economy and especially the travel industry. This not only in the Western world, but also in China (which is hard to imagine at the moment given the rigid Corona policy on the ground).
2. It may turn out that central banks will have to refrain from aggressive interest rate hikes in a few months. Reasons for this could be lower inflation, a deteriorating economic situation or high government debt. In such a scenario, gold and gold securities would be a worthwhile allocation.

Finally, we would like to point out that long-term investors should stick to their core beliefs and good investments. Good companies will survive and thrive in any environment. The current environment is not a reason for excessive pessimism, but at best for increased vigilance.

P. Cettier

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[2] *IC No. 25 Mainstream* from August 18, 2021

[3] *IC No. 26 Outlook of Outlooks* from December 9, 2021