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BODMER CETTIER

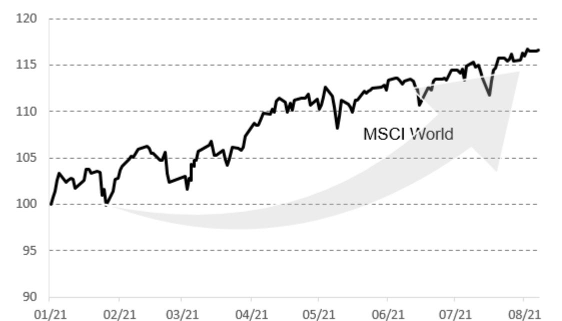
Zurich, August 17, 2021

IC No. 25 – Mainstream

The investment year 2021 has been comfortable so far. Investors were able to let themselves be driven by the main current in the market (the "mainstream"). What we stated in *IC No. 22 - Outlook of Outlooks* as the consensus of market participants came to pass: The continuance of the equity rally in 2021. So the MSCI World Index, gained around 16% by mid-august.

Drifting with the main current

Development MSCI World 01.01.21 to 15.08.21 in %



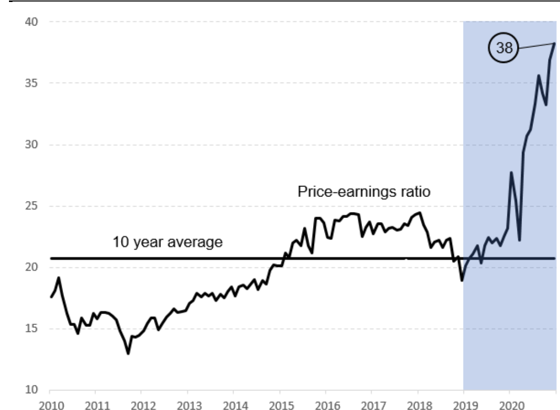
Source: Financial database

The sustained rise in asset values is neither surprising nor new. The familiar explanations can be found in a mix of cheap money and yield-hungry investors. In addition, companies are earning splendidly and exceeding their own forecasts and market expectations in the majority of cases. It remains to be seen whether catch-up effects will play a decisive role or whether we will move onto a new growth path.

Rising prices are accompanied by rising price levels. In the following graph, we have shown the 10-year average of the price-earnings ratio using the US stock market as an example. This shows a strong deviation from the long-term average, even if we assume that the price level is generally higher due to the generous central bank policy of recent years. For example, the average price/earnings ratio for the U.S. market currently stands at 38, 84% above the 10-year average. This is a remarkable level, considering that value-oriented investors have in the past become restless at price-earnings ratios beyond 20.

Strong increase in price level

Development of the price/earnings ratio of the S&P 500



Source: Financial database, own illustration

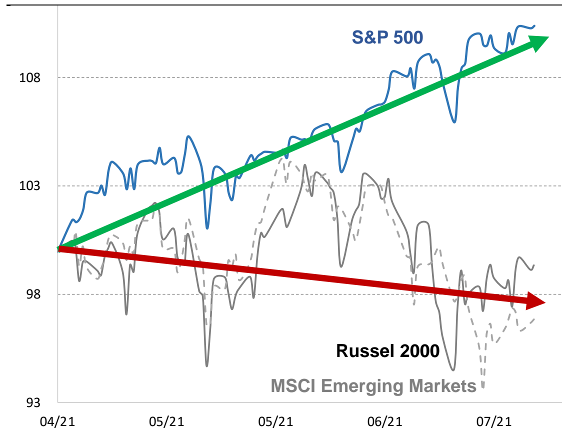
Conversely, the increased price level also means that the safety margin for investors has decreased. Accordingly, it is important to keep a watchful eye on market developments.

Signs of rising risk aversion?

In our search for possible signs of rising nervousness and increasing risk aversion in the market, we noticed the divergent development between the main market S&P 500, which is dominated by mega caps, and the secondary markets Russel 2000 and MSCI Emerging Markets. What was still a broad-based rally in Q1 narrowed down to high quality assets in Q2. Large-cap and high-revenue companies from developed markets were favoured. Small-cap companies and emerging markets were avoided. A turning point in the market?

Main stream first[1]

Main market: S&P 500; Secondary market: Russel 2000, Emerging Markets



Source: Financial database

The described divergence between core and opportunity stocks, which manifested itself especially in Q2, is relevant for us in the context of market sentiment analysis. Historically, such a divergence has been interpreted as a retreat of investors to "safe" stocks: Staying invested, but in the core stocks and markets. This development can certainly be interpreted as a sign of rising risk aversion. Accordingly, it is particularly important to rethink one's portfolio positioning in such a market situation.

What we don't know

Investing has been uncertain since the existence of capital markets, as we do not know what will happen in the future. Weighing up the opportunities and risks is part of the business. What we don't know, for example, is how the COVID 19 situation will develop, whether inflation is just a temporary phenomenon or we have entered a phase of strongly rising prices, whether the most powerful central bank in the world (the FED) will withdraw liquidity from the market (tapering) and how market participants will behave in this regard and in general.

What we know

As an investor, you should stay invested because the capital markets will reward a long-term commitment with a very high probability. At least the last 100 and some years of modern capital market history suggest that. Also, breakthrough innovations give reason for optimism (think e.g. of the mRNA technology of Biontech and Moderna). Therefore, it is not completely far-fetched to assume that long-term returns on the capital markets will be similar to those in the past on average and over a longer period of time. In the short term, as always, "everyday problems" (like the daily weather) will prevail. The current elevated price levels make corrections more likely. From a tactical point of view, therefore, a close look at the personal risk budget is in order. In addition to the question of an anticyclical reduction of the equity quota, we see the question of the composition of the equity portfolio as a sensible task. Currently, we prefer a somewhat more defensive mix of major and minor stocks. Among the major stocks, we include the usual suspects such as Nestlé and Roche. Among the second-tier stocks, we include companies such as Bobst, Swissquote or Zalando, which could be more susceptible to setbacks after significant advances.

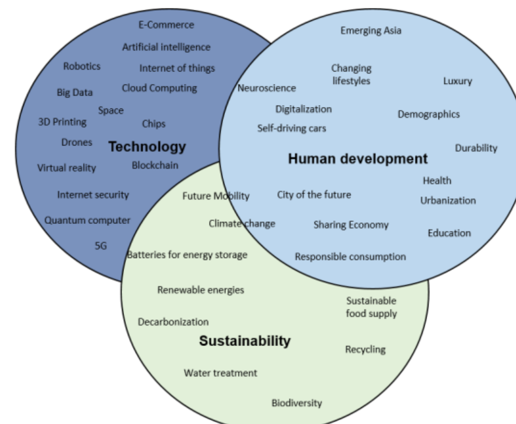
The classic work of an investor

Another consideration to protect against capital losses could be a return to the classic work of an investor and capital provider. By this, we mean not so much the narrow view of stock analysts, but the view and thinking of companies and the understanding of the market position of companies. What added value does the company offer its customers? Why is the company better than its competitors? Why will it be even more successful in the future?

Provide for the future

In addition to the more short-term issues surrounding current portfolio positioning, it also seems sensible to us to think about new and long-term investment opportunities. That is why we at Prio Partners are also focusing our attention on the megatopics of the future. The topics of technology, sustainability and human development not only promise a better life, but are the breeding ground for the success stories of the next decade.

Mega-topics of the future[2]



Source: Prio Partners

More on this in the next investment commentary.

P. C.

[1] In the chart, the main U.S. market S&P 500 represents the developed markets. The Russel 2000 represents small-cap stocks and the MSCI Emerging Markets the developing and emerging markets.

[2] Not a final list.