PRIO PARTNERS
BODMER CETTIER

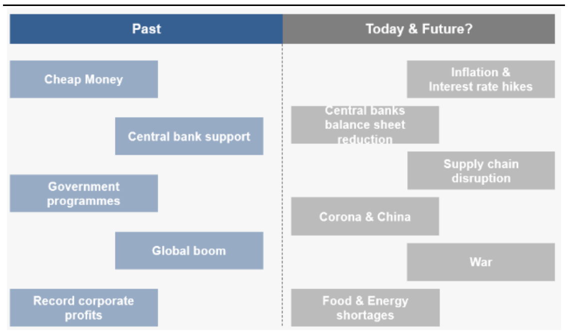
IC No. 28 – In shock

Zurich, 6 May 2022

We are all shocked. The situation in Ukraine is so unbelievably terrible, the war so inhumane. In a way, the feeling of being paralysed by shock has also transferred to the stock market and investors. What to do? Where to flee?

After a decade of structurally falling interest rates, a central bank liquidity party, government support programmes during the coronavirus pandemic, a global economic boom that was just rebounding with record corporate profits, now comes the shock. Will it be a breakneck ride with our foot on the gas that ends in an emergency stop? The risks are known, but is the market underestimating the events that are lining up like in a nightmare? The central banks are "turning off the music" (reducing central bank balance sheets and withdrawing liquidity), and inflation is spiralling out of control. Supply chain disruptions were already evident during the pandemic and now, combined with the war in Ukraine and Russia's isolation in the critical areas of energy and food, they will lead to famine and uprisings in the less developed countries.

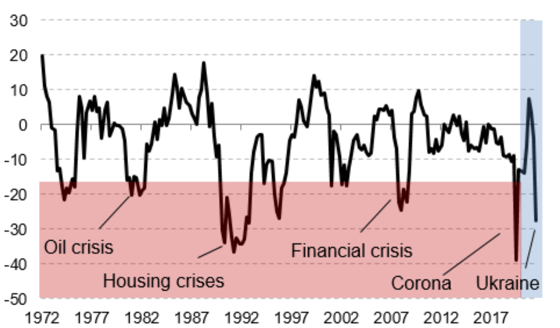
From full throttle to an emergency stop
Trend reversal on the markets



Source: Prio Partners

In our last investment commentary of February 2022, *IC No. 27 – Beauty and the Beast*, we focused on the already threatening inflation and its consequences. From many conversations, we occasionally get the impression that inflation is misunderstood by investors in particular. After all, investors have profited from rising prices in the last decade! In technical jargon, we call this monetary inflation or "asset price inflation". Cheap interest rates and rampant liquidity were reflected in ever-higher prices for bonds, shares, real estate and all kinds of alternative investments (e.g. venture capital or private equity). For our clients and us this is a great thing, but for all those who had no money to buy their own property it was a disaster. Nevertheless, none of this was so bad as long as the goods of daily use were affordable. The situation already changed abruptly in this respect during the coronavirus pandemic, and now even more so with the war in Ukraine. It is squeezing people's wallets and threatening the standard of living of the population at large. Known as supply-induced or headline inflation, this type of inflation hits consumers hard. This can be seen in consumer sentiment, which has plummeted to record lows even in Switzerland.

Consumer sentiment is falling rapidly
Consumer Sentiment Barometer Switzerland, 1972-2022



Source: Prio Partners, SECO

The role of central banks

We now ask ourselves what exactly the central banks want to fight with interest rate hikes. From a neutral perspective, combating monetary inflation would have made sense a long time ago. That is, to curb exaggerations on the capital market and the misallocation of capital through the missing steering mechanism of interest rates ("hurdle rate"). In our view, this opportunity was missed long ago. We already wrote about this topic in our first investment commentary of 2016 *IC No. 1 – What is worth what?* However, central banks cannot directly combat supply-induced inflation with interest rate hikes – after all, what does an interest rate increase have to do with a shortage of wheat from Ukraine that causes the price of bread to skyrocket? The effect of interest rate hikes on supply-induced inflation is only indirect: prices only fall when supply increases again or when demand is curbed. So the central bank is slowing down the economy with interest rate hikes, everyone is consuming less, and supply and demand are entering into a new, lower equilibrium. We are therefore talking about sacrifice and the associated reduction in our standard of living. The following chart of 10-year US government bonds shows how dramatic the interest rate turnaround is.

US bonds rally strongly

Development of 10-year US government bonds over the last 5 years

Source: Prio Partners, financial database

For us investors, rising interest rates mean a revaluation of assets. We can illustrate this by consulting a simple valuation model and considering how the individual factors are influenced. The arrows indicate the direction of the expected change in the valuation factors. The colour red shows the negative effect on the valuation of assets.

Simple valuation model

Gordon growth model (dividend discount model)

$$Price \downarrow = \frac{Dividend \downarrow}{((Risk\ free\ rate \uparrow + Risk\ premium \uparrow) - Growth\ rate \downarrow)}$$

Source: Prio Partners, Gordon (1959)

We believe that corporate margins (e.g. in manufacturing) will come under pressure. This could have a dampening effect on dividend payments. We also anticipate that the development in interest rates will cause the risk-free interest rate to rise. The risk premium (i.e. the risk aversion of market participants) will also increase due to the risks mentioned. Developments in Ukraine and the division of the world into blocs also will not contribute to longer-term economic growth.

Assessment and positioning

Stagflation seems to us a very real prospect and we believe that the bad news on the corporate side is yet to come. Our assessment is a continuation of the recommendation we already made in *IC No. 27 – Beauty and the Beast*, as the war in Ukraine has accentuated the issue of inflation once again.

We recommend a defensive, selective allocation (e.g. pharmaceuticals), underweight Europe and value cash and gold. In the following attractiveness matrix, we would like to give you our current assessment of the selective allocation at sector and regional level.

Prio Partners attractiveness matrix

Current assessment by sectors and regions

	Switzerland	Europe	North America	Asia
Energy		+	+	+
Industry	–	–		–
Materials	+	+	+	+
Consumer Staples	+		+	+
Consumer Durables	–	–	–	–
Health	+		+	+
IT	–	–		–
Communication		–		
Finance		–		–
Transport	+	–	+	+
Real Estate	+	–		
Overall	+	–	+	

Source: Prio Partners

Investors should not allow themselves to be driven into overpriced investments by inflation headlines and the threat of negative interest rates from custodian banks. Neither is really relevant if it comes to a significant correction. Perhaps the motto for 2022 will be "cash is king".

Dr Patrick Cettier