PRIO PARTNERS

BODMER CETTIER

## IC No. 30 – Wrap up warmly

Zurich, 30 September 2022

In Europe, we have to wrap up warmly in many respects. Not only in terms of energy bottlenecks, but also with regard to bad corporate news and longer-term consequences. There is a risk that the economic decline, which has been rather gradual until now, will go into fast-forward mode. The dependence of the European economy on energy imports is Europe's Minsky moment. Start-ups are unable to find financing and are laying off staff, PE deals and real estate transactions are undergoing a historic decline, IPOs are being postponed and companies are having to file for bankruptcy by the dozen. The real estate market is wobbling. The trend on the bond and equity markets is painful. Currencies are derailing. The eurozone is in crisis mode. But the signs are also bad worldwide. Central banks are raising interest rates at an unprecedented rate and trying to curb inflation by putting the brakes on the economy – while at the same time accepting millions of unemployed. Spontaneously, this does not seem ideal to us. The situation in China does not bode well, either, with the lockdowns, energy crisis, water crisis, export decline and a faltering real estate sector. And Taiwan.

For companies, this means tightening their belts. There are fears of a drop in sales and significant pressure on margins. The recent increase in producer prices in Germany by a staggering 45.8%[1] makes every entrepreneur tremble (except Mr Habeck, but he isn't an entrepreneur). The only question is how deep the recession will be. Are we too pessimistic?

**Strategic optimism**

From the many intensive market discussions of recent times, we would like to highlight a conversation with one esteemed interlocutor, founder and head of a multi-family office. He coined the term "strategic optimism" in the context of market considerations. By this, he meant a long-term and constructive view of the world, with the emphasis on quality companies, structural growth themes and innovation. Accordingly, these must be identified and implemented in the portfolio context. We agree with the longer-term strategic view, but we also believe that the real upheavals in the economy and the capital markets need to be specifically addressed in the portfolio context. After all, the massive increase in risk aversion among investors is justified.

**Current positioning**

How do we handle asset management in this environment? We have record high cash holdings of 30% to over 50% in both multi-asset and equity mandates. In terms of stock selection, value and core stocks predominate. We hold hardly any euros or British pounds, even in euro reference portfolios. The euro was never in vogue in Swiss reference portfolios anyway. Our position is clearly defensive, and we are wrapped up warm in a thick coat, hat and scarf, so to speak.

**Specific implementation options**

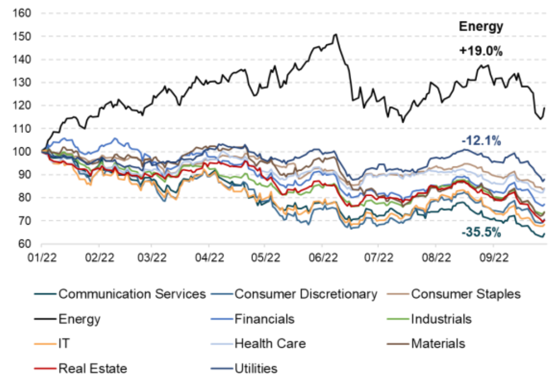
Our main question is how we can act intelligently over the next 6 to 12 months to position the portfolios for the continuing tense situation while preparing for the future.

*Equities*

The development at sector level shown in the following chart is clear: only the energy sector has benefited from the sharp rise in energy prices this year. All other sectors are significantly in the red, with the market differentiating between cyclically sensitive sectors and less cyclical sectors.

**Energy sector swings up top**

Sector development year to date, indexed, in %




Source: Prio Partners, Bloomberg

We believe that the developments to date will continue in the near future. Accordingly, we continue to regard companies from the energy and commodities sector as interesting. In addition, this sector is underrepresented in many portfolios and there is catch-up potential. Beyond that, the less cyclical sectors are still to be preferred.

[1] Handelsblatt of 20 September 2022

*Option strategy*
We have started selling put options on selected stocks.[2] This is because we believe that it is (still) too early to increase the equity ratio. Accordingly, we are collecting the premium of the sold put options in the meantime. If the buyer of the put option exercises their right to sell, then we buy shares at significantly lower prices.

**Premium strategy with rights sales**
Partners Group share price in CHF, put option strike CHF 560


Source: Prio Partners, Bloomberg

For comprehension purposes, here is the basic data for for the example listed:

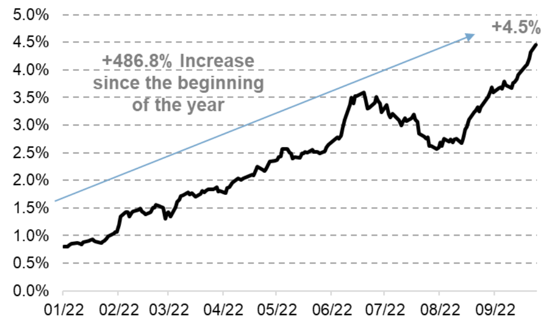
*Sell put option on Partners Group*
Calculation as of 26.09.2022
Maturity: 17.03.2023
Strike: CHF 560 (70.5%)
Current share price: CHF 794.40
**Option premium: CHF 17.25 (3.1%)**
Break-even: CHF 542.75 (560 – 17.25)

From our perspective, this is a prudent forward strategy to invest your cash if you share the "strategic optimism" we have formulated but currently want to act defensively.

*Bonds*
We know it sounds strange, but it seems to us that bonds are becoming interesting. The following chart shows the dramatic +486.8% rise in bond yields since the beginning of the year. With an average bond yield for BBB+ bonds of +4.5%.

[2] With this, we sell the right to sell equities to us at a certain price (strike) and collect a premium in return.

**Buying opportunity in the bond market?**
BBB+ corporate bonds EU region, yield to maturity in %




Source: Prio Partners, Bloomberg

We believe that central banks cannot raise interest rates much further. The level of debt in the economy is simply too high. To stay with our clothing analogy, the highly indebted market participants are slowly "having their trousers pulled down". Accordingly, after many years of absence, we see bonds as a possible addition in a multi-asset mandate (despite inflation).

**Expectation and outlook**
Our expectation is that corporate earnings in Q3 and Q4 will be poor and that many companies will reduce their forecasts or cancel them altogether. The reaction of market participants to such news will clearly be negative. If we look beyond this into the first half of 2023, our stance regarding the price level on the markets is definitely somewhat more constructive.

For guidance, we have listed various criteria below that should provide orientation with regard to a potential bottoming out on the market.

**Orientation in tough times**
Price level, market sentiment and fundamentals

| Criterion | Status Quo |
|---|---|
| Market drawdown > 40% | On average -20% |
| P/E < 12 | Currently still over 15 |
| VIX > 50 | Currently at 30 |
| Earnings downgrades | Little so far |
| Peak Inflation | Potentially reached |

Source: Prio Partners

Since, in our opinion, we are still some way from a clear bottoming out, we continue to advise a defensive stance for the near future with a pinch of intelligently packaged optimism in the new year.

*Dr Patrick Cettier*