Zurich, June 27, 2023

IC No. 32 – The noise of the trees

One of the advantages of capital markets is that investors can participate in the world's best companies with the click of a button. However, with a wide range of options comes the dilemma of choice. Where does it make sense to invest, and where should one refrain? Another challenge for many investors is the constant availability of real-time updates on current stock prices. The temptation to trade is strong. However, stock investments should be approached like a marriage rather than speed dating. It is wise to carefully consider before making a decision. Therefore, the daily monitoring of stock prices by some investors may seem like watching trees grow, causing them to startle at every rustle and question their stability. The beauty of trees, assuming they receive sufficient light and water, is that they continuously evolve and grow. Sometimes more, sometimes less, as reflected in their annual rings. Thus, symbolically, trees represent tranquility and strength to us. The proverb holds true for hasty approaches: " In and out, the pockets go about."

Of course, we are repeatedly asked for our opinion on the current market situation. The transaction-oriented investor is always on the lookout for foolproof tips for quick profit. However, we have learned that these tips are more likely to result in significant losses rather than the desired profit. Therefore, we prefer to think in principles and develop our own big picture, which forms the basis of our investment decisions.

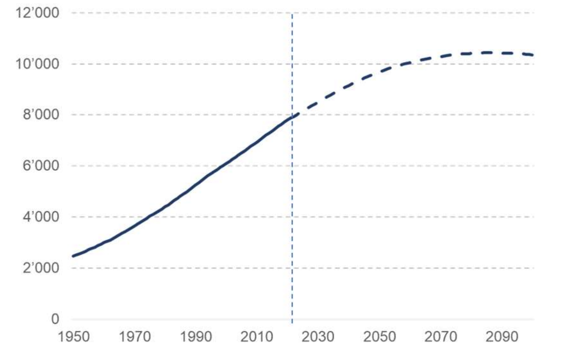
The long-term trends are clear:

1. Global population growth will continue in the coming decades.
2. The prosperity of the world population is increasing.
3. Technological advancements continue to progress, driving the productivity of companies forward.

These factors clearly support investing in stocks in the long term.

1. The world continues to grow...

Development of global population growth, in millions



Source: UN, Prio Partners

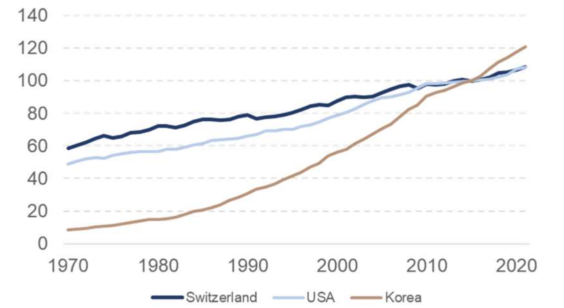
2. Rising prosperity

Development of world GDP per capita, in USD, at current prices

Source: IMF, Prio Partners

3. Technological advancement enhances the productivity of companies

GDP per hour worked, in USD, 2015 = 100



Source: OECD, Prio Partners

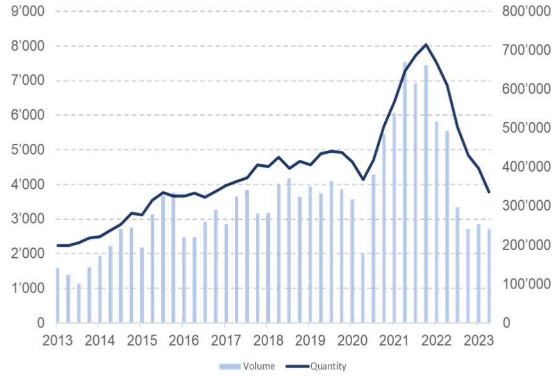
Maintaining balance
As market fluctuations can be quite significant (e.g., 2001-2003, 2008/2009, 2020, 2022), many investors prefer a balanced approach. This involves comparing the attractiveness of available asset classes and constructing a complementary portfolio. The question of how much risk an investor is willing to take also plays a crucial role. The good news for investors who prefer a balanced approach is that the current market environment offers more opportunities for such a strategy. In addition to the returns from stocks, bonds and cash now also generate interest yields.

During the period of negative interest rates, which, like the COVID-19 pandemic, is not too distant but quickly forgotten, the cautionary voices grew louder as central banks artificially kept interest rates near zero for an extended period. Savers were indirectly expropriated, and speculation was effectively supported through cheap money with state backing. There were also warnings that it would be challenging to ever raise interest rates again (referred to as "Japanification"). Now, due to immense inflationary pressures, interest rates have risen sharply in a short period. In our opinion, interest rates were kept too low for far too long and are now being raised too rapidly and aggressively. We are critical of the activism of central banks, and it appears that they are being carried along by developments rather than taking a proactive stance.

After the collapse of the Silicon Valley Bank due to the rapid increase in interest rates, things have become too quiet for our taste. We believe that many highly leveraged investors are facing challenges, whether in the venture capital sector, (commercial) real estate or private equity. So far, there have been no significant domino effects. We do not wish for such a scenario, but we would not be overly surprised if it were to occur. Depending on the level of leverage, the sharp rise in interest rates can have significant negative consequences due to the leverage ratio (the ratio of equity to borrowed capital). Projects quickly become unviable, and financing dwindles. The elevated interest rate environment and the described effects are also evident in the markets. Both completed deals in the private equity sector and real estate sales have declined significantly. There are fewer transactions as sellers want to sell at yesterday's prices, while buyers want to purchase at tomorrow's prices.

Correction in the leveraged business

Global private equity deals (number and volume)



Source: Bloomberg, Prio Partners

As another observation, we note that the recession that market commentators have been predicting for some time has not materialized yet. However, recent negative news from companies, such as the billion-dollar write-down at Siemens Energy and order declines at VAT, is now causing concern. An indicator of deteriorating sentiment is the Purchasing Managers Index, which is now predicting a recession.

Economic sentiment indicator

Purchasing Managers Index (USA), March 31, 2000, to May 31, 2023

Source: Bloomberg, Prio Partners

Often, the Purchasing Managers Index (PMI) has also been a contrarian indicator. Low points in the past have always presented buying opportunities.

Having your cake and eating it too
In summary, we currently see opportunities for balanced multi-asset, multi-strategy approaches. We recommend taking advantage of the high interest-rate environment by including long-duration bonds in portfolios. When interest rates are high, it separates the wheat from the chaff for companies. Therefore, we recommend avoiding experiments on the equity side and prefer large, well-capitalized companies with strong market positions.

Dr. Patrick Cettier