Investing in Value & Values.

To:	CIIM Co-Investors only	**Memo**
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Subject:	**The big picture: Paradigm Shift**	

The world is returning to normal. TINA is once again a woman's name. The term FOMO finds its place in the books of financial history. Investments in value stocks as well as bonds will take their place in asset allocation again in the future. A paradigm shift towards rising interest rates is taking place.

What happened?

1. Graph

Quelle: Bloomberg, yield 10-jährige American Treasury Bonds (17.1.1962 – 17.1.2023)

During the high interest rate period from the beginning of 1970 to September 30, 1981, when yields on 10-year U.S. government bonds peaked, U.S. equities returned not quite 4% p.a. In the subsequent 41 years to the end of 2022, by contrast, they posted an annualized return of 10.75% before costs.

The explanation is obvious: high or rising interest rates reduce the value of future cash flows and thus the value of a company. Since their peak in 1981, equity investors have been richly rewarded by falling interest rates for more than 40 years, a trend that only reached its end after reaching negative territory.

Towards the end of this period, risk aversions were thrown overboard, and greed spread. Until finally TINA and FOMO ruled the financial markets.

Worshipped were the FANG shares, for which an index was built specifically. The shares of Amazon are also part of this and in August 2020 were worth 1.5x as much as all of the over 300 shares contained in the Swiss Performance Index (e.g., Roche, Novartis, Nestle etc. (SPI) were. Well, the tulip bubble was bound to burst sooner or later.

Today, the tables have turned 180°. The SPI shares are now worth 1.5x as much as the Amazon shares. Despite a halving of the price, however, Amazon's shareholder securities are anything but a bargain with a P/E ratio of 98x and a KBV of 7x.

The loose monetary policy not only led to extraordinary price increases for conventional asset classes and real estate, but also made everyday life immensely more expensive. In the USA, the price of everyday goods rose by 9.1% at the peak. This has since weakened to 6.5%. In Europe, 10.6% was measured at the peak. In the meantime, it stands at 9.2%.

The effects of falling interest rates

Falling capital costs and the immense liquidity provided by central banks led to the intended stimulation of the economy, corporate profits and thus also the financial markets. Historically unique, strongly overvalued bonds with negative yields were the consequence. In other words, investors were not only willing not to be compensated for the debtor risk, but they paid for it!

There was little fear of insolvencies, as the central banks provided a major boost to the economy by opening the money spigots.

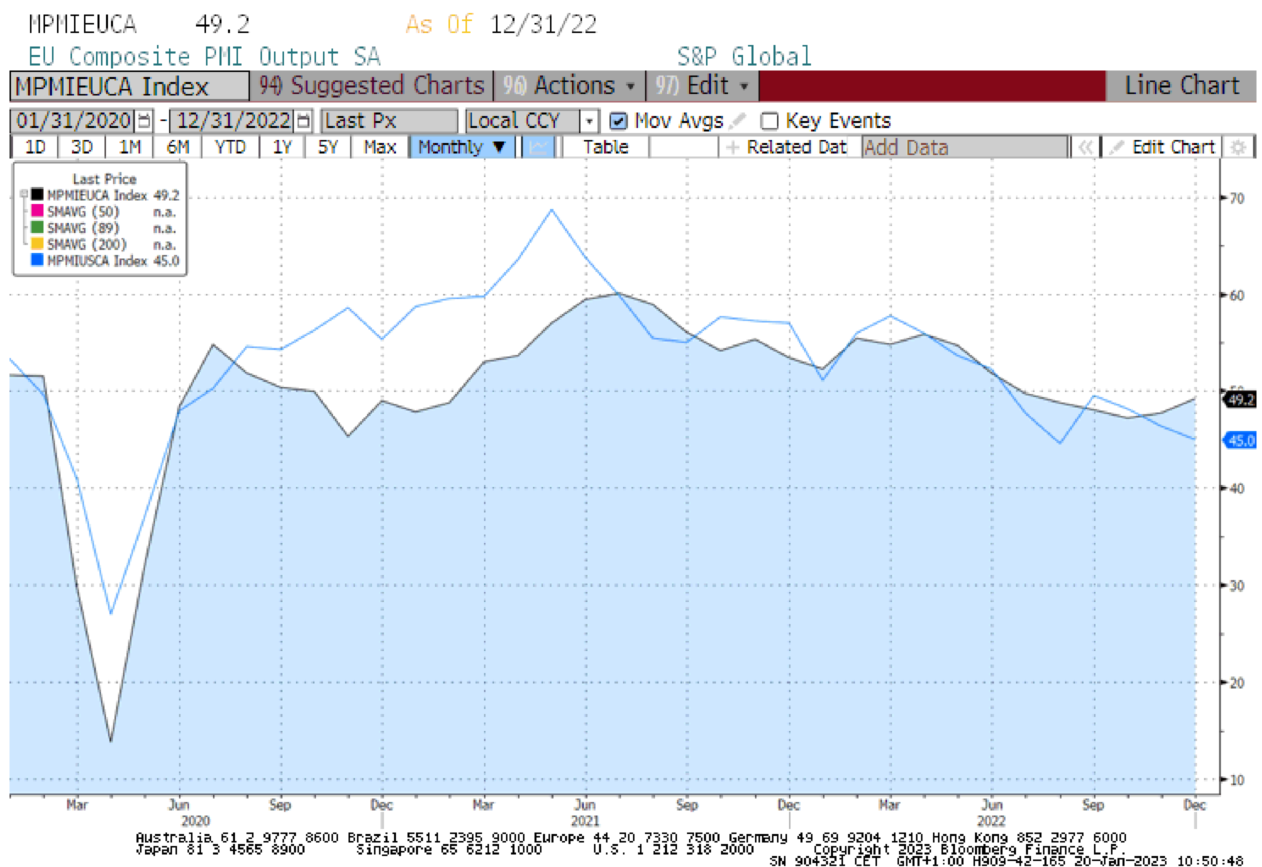
Discounting future cash flows using a negative risk-free interest rate made little mathematic sense, which is why growth stock valuations shot through the roof to eventually become unaffordable.

Actual state

The two purchasing indices shown (2nd chart) suggest a slowdown in economic activity. Consequently, demand for commodities and goods will also weaken, which in turn is likely to be reflected in lower consumer price indices in the short term.

However, we believe that higher inflation (>2%) will accompany us for a long time in the medium to long term. The "de-carbonization" in Europe will entail investments, which will be passed on to consumers in the form of higher prices.

2. Graph



Quelle: Bloomberg, American Purchasing Manager Composite Index (blue); European Purchasing Manager Composite Index (schwarz) 31.01.2020 – 31.12.2022

Another aspect is the pent-up demand for consumer goods after the pandemic. It overwhelmed the long supply chains, reduced supply, and had a devastating impact on trade activities. Western economies are responding by relocating production sites to the geographic proximity of end users, which in turn will have a negative impact on price.

Another factor will be the baby boomers. They will reach retirement age, which means that they will no longer be available as employees to the same extent. Since the loss of labor cannot be replaced 1:1 by younger workers, wages and investments in (automation) technology will rise, which in turn will lead to higher product prices.

Since the Great Financial Crisis of 2008/09, the global money supply has increased six-fold relative to economic output. This high level of debt was bound to lead to inflation at some point. Since,

unlike tax revenues, which provide for redistribution, demand was produced via debt, newly generated money faced a constant or, in this case, reduced supply.

The central banks therefore have their hands full before the next crisis looms. On the one hand, they are tackling inflation with higher interest rates, on the other hand, they are reducing the bloated central bank balance sheets as long as possible.

The Consequences of rising interest rates

Rising interest rates, i.e. rising capital costs, as well as tight liquidity will lead to the intended weakening of the economy and inflation. This in turn will put downward pressure on bond prices. Insolvencies will rise and the holder of bonds will finally be compensated again for the debtor risk taken.

The valuation of future cash flows makes mathematical sense again, and risk/return considerations are also relevant again.

The world is returning to normal. TINA is a woman's name again. The term FOMO finds its place in the books of financial history and investments in substance stocks as well as bonds will have their place in asset allocation again in the future.

Macro

There is a high probability that we are already in a recession in the United States and in Europe. However, investors believe that the recession will be much milder than was expected back in October.

Conclusion

Two-thirds of the gross national product of Western industries is generated by consumption. As purchasing power dwindles, this will be felt by the economy, businesses and ultimately consumers.

There is a paradigm shift toward sustained rising interest rates.

Therefore, stock selection will be of great importance in wealth creation in the future. See our report in cooperation with the University of Liechtenstein: "Inflation Immunization with Stocks - Is enhanced return generation possible?

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