



MARKET COMMENTARY

BERGOS
PRIVATE BANK



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As Bergos' Chief Investment Officer, Till Christian Budelmann regularly comments on events on the international capital markets and examines them in the context of economic and political trends. Budelmann is member of the bank's executive board and heads the investment committee.

STOCKS OF COMPANIES WITH PRICING POWER SHOULD FORM THE CORE OF ANY PORTFOLIO

Equities and bonds are down sharply, a global recession is likely at the end of the year, and inflation has proved to be more than just a temporary problem, but one that will last for a while. This is not an easy environment for investors, said Till Christian Budelmann, Chief Investment Officer at the Swiss private bank Bergos. In his opinion, however, a flight to cash is not a good strategic option, as that would amount to value destruction in these inflationary times. Instead, investors should focus on solid quality companies that are able to pass on higher costs to their customers.

Since it was first published in the 70s, the Bloomberg US Aggregate Total Return Index had never fallen by as much in a single calendar year as it has so far in 2022. But what is even more decisive: In those years since 1977 when the US S&P 500 equity index was down, the key benchmark for the bond market was always higher or at least flat, as in 2018. This offsetting effect has failed to materialize in 2022. Both equities and bonds have posted double-digit percentage losses. The correlation between these asset classes has not been this high since the mid-90s, when equities and bonds were both advancing, however.

The explanation for this development, which is observable not only in the United States, can be found in the general economic situation, which is plagued by fears of recession and worries about inflation. "The extreme pullbacks in the first half of the year probably represented the pricing-in of a real recession that will only begin much later", Till Budelmann said. Rising interest rates as a result of inflation and inflation itself are depressing consumption and growth across the world. The probability of an economic slowdown to the point of an actual recession has risen considerably.

Recession at the end of the year

Based on preliminary numbers, economic output in the United States has already contracted in two consecutive quarters. "While this is already considered to be a technical recession, it is not yet a broad-based recession given that the labor market is still strong", Budelmann said. He expects such a broad recession to occur only at the end of 2022 and beginning of 2023, although the drop in US economic output will likely be relatively mild. Europe is likely to be in recession already at this point, and the contraction of the economy over the winter is also likely to be more severe than on the other side of the Atlantic. While the war in Ukraine and tight energy supplies are indeed global issues, they are especially burdensome for Europe. Worries about natural gas supplies are currently putting great

strain on the German economy in particular. Already now, natural gas is eight times more expensive in Europe than in the United States. Nevertheless, investors should **not** be overly afraid of a recession, Budelmann said: "It is indeed unpleasant, but it is part of the economic cycle and can have a cleansing effect. Moreover, a recession mainly endangers companies that investors should avoid anyway."

Inflation scares many people

Another factor contributing to uncertainty in the markets is the high rate of inflation. "We find ourselves in an inflationary regime. It is **not** temporary, but will last for a while. Inflation scares many people because they have never experienced it", Budelmann explained. The loss of purchasing power is all too real for many. Employees are demanding higher pay. Given the scarcity of skilled workers, companies are compelled to accommodate these demands at least in part and are seeking to pass on the higher costs to customers. Budelmann: "Once such a wage-price spiral takes off, it is very hard to stop. However, this is not yet the case."

Central banks are seeking to curb inflation by raising interest rates. "One can only hope that, on the one hand, the Fed's measures will bear fruit and, on the other hand, that inflationary pressure will ease on the supply side, for example by easing supply bottlenecks, before the wage-price spiral intensifies and loops further, Budelmann said. He expects that the rate of inflation in the United States will stabilize in a range of 3 to 5 percent next year, while for the Eurozone he predicts an inflation rate of 5 to 7 percent, which would still be less than the current rate of 9 percent."

Investing in inflationary times

In the current environment of uncertainty, many investors are inclined to build up a strategic cash reserve. This would be a mistake, according to Budelmann: "Cash is **not** a good strategic option in these inflationary times. In real terms, it loses value every day." He is also **fundamentally** cautious about bonds: "In the current environment of inflation and possible further increases in interest rates, bonds will **not** be able to hold value in real terms." For diversification reasons, however, bonds should still be a part of a balanced portfolio. Likewise, gold belongs in every multi-asset portfolio as a hedge against major crises. However, this precious metal cannot be the core element of an investment portfolio.

High-quality shares should form the core of any portfolio

This role must still be played by equities, which are closest to providing protection against inflation, at least in the case of companies with pricing power, which are able to pass on higher costs to their customers. They should have low debt, stable business models, strong competitive positions, solid balance sheets, and high levels of cash. "Such companies reported significant, year-over-year profit growth in the second-quarter reporting season", Budelmann said, while also warning that: "Despite solid profits, the prices of such quality stocks are extremely volatile at the moment. Equity investors should be willing and able to withstand that."

Budelmann still sees greater opportunities for investors in the United States than in Europe, **not** only due to the better economic situation in the United States, but also because of a more flexible central bank policy. The European Central Bank (ECB) is lagging behind the United States when it comes to tightening monetary policy. The consideration of different developments in the individual countries makes decisions more difficult and gives the ECB a credibility problem. For example, the neighbouring Swiss central bank has already set new priorities ahead of the ECB.

In the current environment, Budelmann considers active selection to be **even** more important than regional focus: "The days of index investments are over". However, he warns against excessive bargain-hunting because investors could quickly find themselves saddled with junk. Instead, he recommends carefully selected quality companies with pricing power.



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