lemania
investment commentary

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2022 has been an unusual year

Foreword

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Investors have had a rough ride in 2022. The year's first half was catastrophic, with all asset classes delivering sharply negative returns. The bond-market bubble burst in spectacular fashion thanks to an unprecedented rise in inflation that central bankers didn't see coming. Adding to this is a war on European soil that's raising fears of a significant energy shortage and a drought in the northern hemisphere resulting from climate change. We have good reason to worry.

CENTRAL BANKERS ON THE HOT SEAT

At the end of June, investors were on the verge of a nervous breakdown, with central banks tightening monetary policy and the global economy on the road to recession.

Financial markets then calmed down in early summer, and inflationary expectations now appear to have passed their peak in the US and other Western countries. Central bankers face a daunting task in maintaining credibility when they cannot raise nominal interest rates above the level of inflation owing to high public debt. Real interest rates[1] , therefore remain negative despite the less accommodative monetary policies, and this situation is likely to continue.

Even the Swiss National Bank (SNB) caught us off guard in June . It raised its reference rate by half a percentage point to –0.25% without any warning – and without waiting for the European Central Bank (ECB). With high inflationary pressures, SNB officials are no longer fretting about the franc's strength; on the contrary, they now consider it a blessing. The Swiss currency has gained significant ground and is poised to keep rising over the long term.

THE END OF AN ERA

As a result of declining population figures, technological innovation, and globalization, Western countries seemed, until recently, condemned to moderate economic growth at best alongside low or no inflation – with deflation an ever-present risk. Then came COVID-19. Following the pandemic, and the outbreak of war, the fundamentals are the same, but capital flows are allocated differently.

Globalization has redistributed wealth worldwide, enabling many emerging-market countries – particularly in Asia – to lift much of their population out of extreme poverty. However, it has also concentrated wealth in developed countries and impoverished parts of the middle class. The threat to consumers' purses and values has given populist parties a boost at the ballot box. The prospect of having to turn down the heat this winter to save energy, in the wake of an arduous public-health crisis, is likely to encourage further politiciansto make empty promises. governments' purse strings must be loosened – not tightened – to help the poorest households.

REORGANIZING THE GLOBAL ECONOMY

We're in a race against time. For companies, this means doubling up on production lines and/ or repatriating them (through onshoring). It will reduce the risk of production disruptions and shrink their carbon footprint. We can expect companies to ramp up their capital spending significantly in the coming years to bring production lines closer and automate them.

Governments will also be called on to spend. Outdated infrastructure needs to be upgraded and renovated, and energy supplies must be secured – mainly through renewable energy. The situation has reached emergency proportions in Europe, with the war in Ukraine and the acceleration of global warming.

Given the need to maintain cohesion and respect budgetary constraints, the European Union will have to get creative: Some spending could be treated as investment, while others could probably be budgeted at the EU level. The high level of public debt should not be an obstacle. In the US, there are no short-term energy supply problems. However, as we've seen with the Inflation Reduction Act – the law recently passed under the Biden Administration – there is a desire to modernize and green US infrastructure.

Global warming, the war, the pandemic, and trade tensions are forcing governments to rethink their energy, environmental and trade models. There is much to be done.

In the coming decade, the shift from what some call " low-cost globalization" to green "glocalization" is expected to trigger an unprecedented wave of investment. At the same time, prices are being pushed up by labor and raw materials shortages and supply-chain problems. Itis something we need to come to grips with.

Labor costs are going up now that China is no longer a source of cheap workers, and energy prices are rising after underinvestment in the energy sector. These two factors – labor and energy – acted as deflationary forces in the past but will contribute to higher prices from now on. We are experiencing a paradigm change, and adjusting to this new reality will take time.

[1] The real interest rate is the nominal rate less inflation. If the result is negative, consumers' purchasing power decreases.

FAVOR EQUITIES

After three years of rising stock prices, investors are now on edge as the sharp rise in interest rates is also putting pressure on risk assets.

In the environment sketched out above, interest rates will continue to climb. Yet this will take years, and it will follow a path that, if graphed, would resemble a staircase. This can be illustrated by the Swiss government's ten-year bond yield: It took 20 years to go from 4.1% in 2000 to –0.6% at the end of 2019. We can now imagine this yield rising from zero at the end of 2021 to 4% in another 20 years. This change, albeit slow, means that bond returns will remain close to zero at best, over the next few years.

Equities offer better prospects at a time of gradually rising interest rates: companies can pass along price increases to consumers, and profits go up.

The Swiss Performance Index (SPI) delivered an annualized return of only 4.8% over the last 20 years, which is below its long-term average of 7.7% from 1926 to 2021. Stocks aren't emerging from a bubble and, with some pockets of exceptions, have been trading below their averages since 2000.

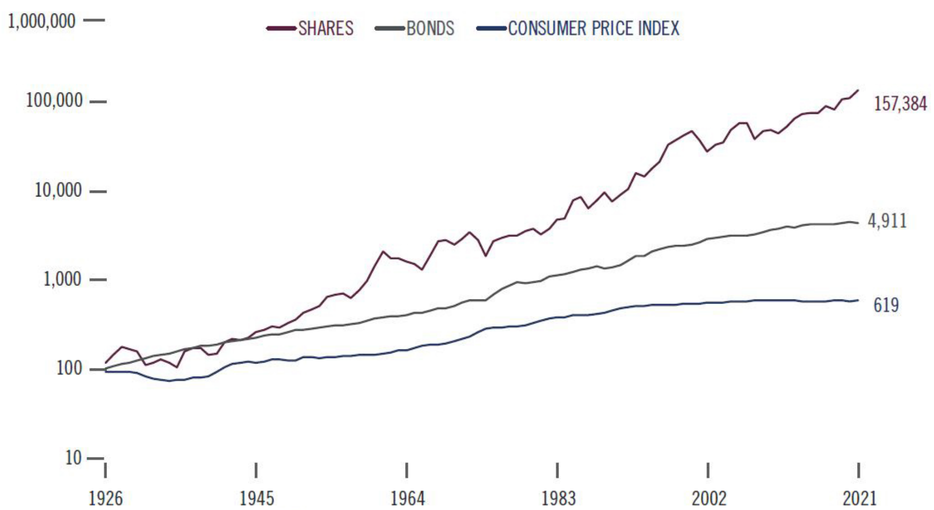
PROTECTING YOUR CAPITAL IN THE LONG TERM

When investing pension assets, where the time horizon is long, it's essential to preserve the purchasing power that future retirees will need. Bond-heavy investment strategies don't do this. The level of risk must be maximized relative to the investment horizon.

Innovation flourishes when people are confronted with major crises, as we saw in the 20th century. The future is uncertain, and we are never safe from the whims of power-hungry leaders or major natural disasters. However, we tend to underestimate our creativity. Louis Chevrolet once said: "If I had asked people what they wanted, they would have said faster horses"

While stock prices can fluctuate significantly, that's also why we get better long-term returns. This additional remuneration makes it possible, over time, to preserve the purchasing power of the amounts invested. Keep this in mind when making decisions about your 2nd pillar pension plan.

Nominal value of shares and bonds versus the consumer price index from 1926 to 2021 (Base =100)



Source: Source Banque Pictet & Cie SA, december 2021