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Investment Letter – 3rd Quarter 2022

With higher interest rates, opportunity costs return

Low inflation rates accompanied by low interest rates have favored high asset valuations. After some 40 years, this trend has reached its temporary peak with the Covid crisis. The structural drivers of low inflation rates are facing headwinds for the first time in many years. Globalization, in particular the full outsourcing of production, has been challenged by geopolitical tensions. Energy supply dependencies have revealed underestimated risks. Technological progress continues to be unstoppable but is currently being held back by supply bottlenecks and is not fast enough to counteract the abruptly changing circumstances. In addition, low unemployment offers employees a promising negotiating position for wage increases.

While the supply side is facing various challenges, the demand side has fully recovered, also thanks to government support, putting additional strain on already troubled supply chains. Various studies have addressed this issue and have concluded that both supply and demand contribute significantly to the current high inflation. Unlike demand, the supply side needs time and investments to overcome these challenges.

The U.S. Federal Reserve is currently trying to curb demand with exceptionally high interest rate hikes, and the other central banks are following suit to varying degrees. From corporate and consumer loans to mortgages, a more restrictive monetary policy is hitting consumers, investors and companies. Until recently, almost cost-free debt capital has enabled financing endeavors that are no longer profitable or sustainable at higher capital costs. Combined with higher prices, especially energy costs, this is expected to cool economic activity until supply chains return to normal and supply can keep pace with demand. Flattening demand is also intended to counteract the tight labor market. This is because broad-based wage increases on the scale of current inflation could set the undesired inflation spiral in motion.

The consequences of higher interest rates on asset prices are very apparent, as we have seen significant corrections. With interest rates and thus capital costs close to zero, there were hardly any opportunity costs in recent years. Accordingly, good marketing was sometimes sufficient to drive up a company's valuation. Tangible near-term profits and sound financial valuation seemed to be less important.

This year has been a stark reminder to investors that it is not enough to simply buy good companies with attractive growth prospects. The price at which it is being bought is just as crucial to the success of an investment in the long term. With the end of the low interest rate environment, the valuation is once again taking center stage. Higher interest rates mean higher opportunity costs and lead to a lower present value of potential future profits. The higher the valuation, the more this base effect comes into play. The speed at which individual companies recover from this correction is thus directly related to how high the valuation was in the first place. Another complicating factor is that the current environment with higher input costs and cooling demand is making it more difficult for companies to increase profits in the short term.

Valuation plays a central role in the selection of our investments. We invest exclusively in above-average quality, but always put this in relation to the valuation. Only if this ratio is attractive, we consider making an investment. We are convinced that a disciplined focus on both factors produces the best results in the long term. This applies to both equities and bonds. As a result of higher interest rates, fixed-income investments are once again a more attractive complement to equities and allow to generate reliable and stabilizing returns in economically and geopolitically uncertain times.

Zurich, end of September 2022