Valvest

Investment View – 2nd Quarter 2022

Review

Record-low interest rates coupled with record-high inflation are leading to deeply negative real interest rates. To correct this situation, either interest rates must rise or inflation rates must fall. Since inflation has turned out to be less "transitory" than central banks had hoped, they now see themselves forced to raise interest rates substantially.

Whereas valuations in recent years were justified by low, and in some cases negative, interest rates, this valuation correction based on sharply rising interest rates is also justified. Capital is always looking for the most attractive return in relation to the given risks. Thus, if the yields of reliable and steady bonds increase, this also requires an increase in the yield of equities to keep the risk premium over bonds constant. This can be accomplished by either increasing the earnings of companies or by correcting the valuation.

The current problem is that interest rates have risen very quickly, and corporate earnings growth has not kept pace. There is also the problem of the base effect. Because of low interest rates, small increases in interest rates are large increases in percentage terms. The same applies to company valuations: the more expensive a company is, the higher the earnings growth must be to compensate for the rise in interest rates and to maintain the risk premium compared with fixed-interest investments. As higher interest rates also have a slowing effect on economic development, companies' earnings growth tends to slow down. Ongoing cost pressure due to strained supply chains and labor shortages further exacerbates this problem.

The risk premium on equities is therefore under pressure from both sides. Higher interest rates combined with presumably lower earnings. Particularly hard hit by this situation are companies with demanding valuations, which must grow disproportionately in order to correct and therefore justify their own valuation. These are precisely the companies that have benefited in recent years from steadily lower interest rates and positive economic development and have received a lot of attention from the media and trend investors.

Outlook

Whereas historically central banks could be relied upon to counter an economic slowdown with interest rate cuts, this time the situation is reversed. Central banks are forced to raise interest rates due to high inflation rates and risk further slowing down the economy. Depending on the severity of the growth slowdown, the current high inflation rates should fall and bring about a stabilization of interest rates. It cannot be ruled out that the current investments by companies to eliminate the supply shortage could even lead to a supply surplus and renewed deflationary tendencies as the economy weakens.

Much depends on the further development of inflation rates and the resulting interest rates. On the positive side, after a long wait, investors in fixed-income investments are once again receiving a return, even if this is not yet keeping pace with inflation. In the event of a return to lower inflation rates, the current interest rates could prove to be an attractive opportunity. The money in the account, on the other hand, is fully exposed to the high inflation rates, but allows at least temporarily to benefit from better opportunities to buy assets.

The challenging situation makes it necessary to focus on proven features in stocks. A leading market positioning secures earnings despite rising costs. Structural growth areas cushion the economic cycle somewhat, and an attractive valuation makes it easier to compensate for any rise in interest rates. Temporary beneficiaries such as commodity companies do not meet our quality requirements in the long term any more than overpriced growth companies did before the correction began this year. Short to medium-term market corrections, on the other hand, are a part of investing and offer attractive opportunities to profit from valuation deviations in the long run.

Zurich, end of June 2022