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Compass

3rd Quarter 2023

The US banking crisis and its impact

The US debt ceiling dispute

Investment implications

Your wealth, our responsibility.

Banking crisis and debt ceiling debate weigh on the US

In March 2023, the US banking sector experienced a severe crisis, triggered by the Federal Reserve's interest rate hikes and risky investments in tech start-ups. Despite efforts by the Fed and President Biden to stabilize the situation, investor confidence was shaken and two banks eventually collapsed while another was taken over. Credit Suisse also suffered numerous financial setbacks in recent years and was taken over by UBS after its stock price deteriorated persistently. To prevent future crises, regulators are now considering even stricter measures to strengthen the financial system. In the meantime, the US Congress was able to reach an agreement regarding the US debt ceiling. Otherwise, the US government could have defaulted with far-reaching consequences for the global economy. In order to relieve the national budget, measures such as tax increases and spending cuts have been considered. We address the current debate and discuss some factors relevant to sovereign debt sustainability. As a continuation of our previous Compass issue, in the final section we examine investment implications arising from the current economic situation. Despite higher real interest rates, we continue to favour equities over fixed-income bonds. However, within equities, we focus less on growth and more on quality. Gold recently posted a significant increase in price and is currently close to its all-time high. However, due to geopolitical tensions and increasing government debt, gold is likely to remain an attractive asset to invest in.

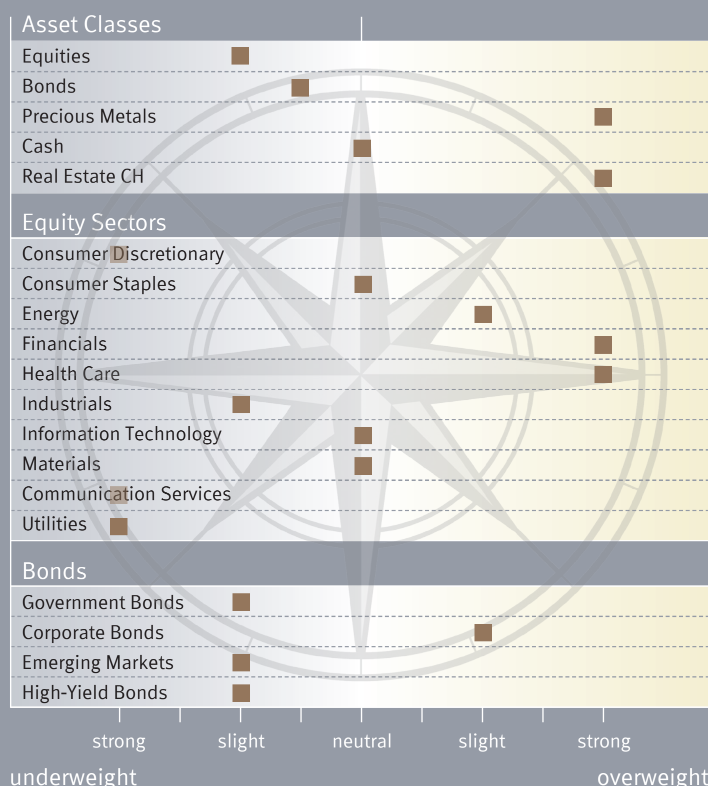
Maintained slight underweight in equities

Global inflation figures remain at very high levels and are only slowly falling from their highs. In addition, the US banking crisis, whose effects were even felt in Switzerland, and the debate on the US debt ceiling have created additional uncertainty in the financial markets. In this difficult macroeconomic environment, we are maintaining our slight underweight in equities.

Compared to the last Compass issue, we have increased the weighting of the industrial sector to a slight underweight due to its attractive valuation and good momentum. As a countermove, we have taken into account the poorer momentum of the materials sector and reduced its weighting to neutral accordingly.

Our allocation to bonds remains unchanged at a slight underweight. We continue to recommend critically assessing the credit quality of issuers and only holding bonds from first-class borrowers. In addition, we still appreciate the defensive nature of gold and maintain a strong overweight.

Asset allocation recommendation as of June 1st, 2023 for investors with CHF as their reference currency.

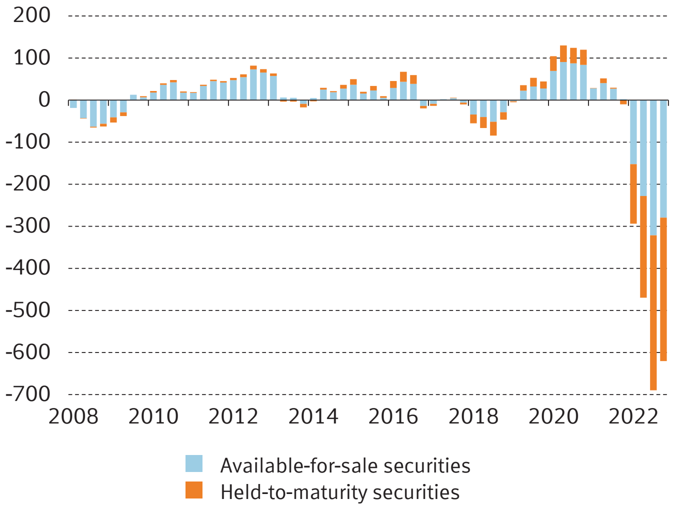


Current Topic:
The US banking crisis and its impact

Current Topic 1:

Source: FDIC

Unrealised gains/losses on investments of US banks in USD billions

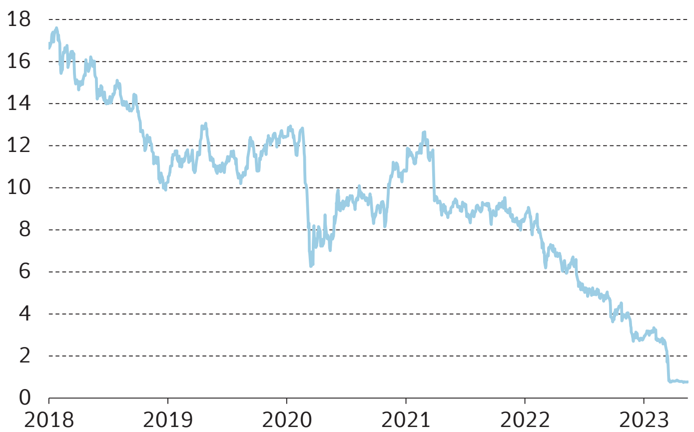


Chronology of the US banking crisis

In March 2023, the US banking sector experienced its worst crisis since 2008. The Fed's interest rate hikes led to large losses in the value of banks' investments, which affected the quality of banks' assets and led to a liquidity squeeze. In addition, Silicon Valley and Signature Bank became distressed due to their investments in risky assets, especially tech start-ups. The subsequent bank runs caused the two banks to collapse, while a third was taken over by a larger financial institution. To stabilise the situation, the Federal Reserve stepped in and President Biden publicly tried to assert the safety of the banking sector. Nevertheless, investor confidence was shaken, leading to a crash in bank stocks.

Current Topic 2:

Credit Suisse stock price in CHF



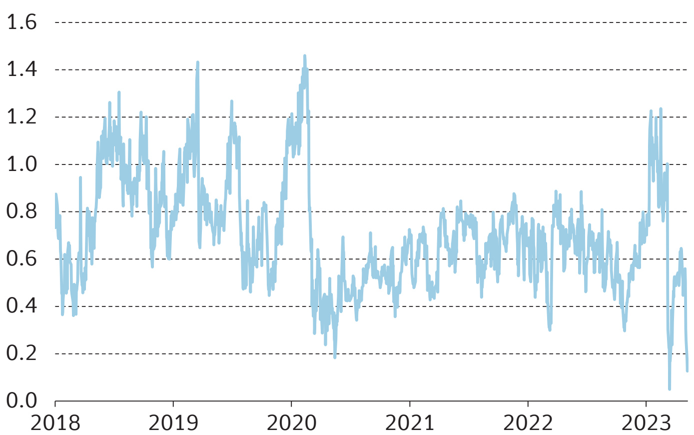
The end of Credit Suisse

In recent years, Credit Suisse has suffered numerous financial setbacks and consequently a loss of reputation, which is reflected in the dramatic fall in the CS stock price. In particular, the billion-dollar losses in connection with the insolvencies of two of CS's business partners, Greensill and Archegos Capital, as well as the internal spying scandal caused investor confidence to wane. Two days after Biden's speech, the CS stock price began a rapid decline, which could not be stopped even by the announcement of SNB emergency aid of up to CHF 50 billion. After discussions with FINMA, the Finance Department and the SNB, UBS finally agreed to a takeover of Credit Suisse for CHF 3 billion on March 19th.

Current Topic 3:

Source: Federal Reserve of Cleveland

Stress indicator for the US banking system



A value of less than 0.1 for more than two days indicates a significant financial stress at which the average bank insolvency risk increases.

Increased regulation after crisis of confidence

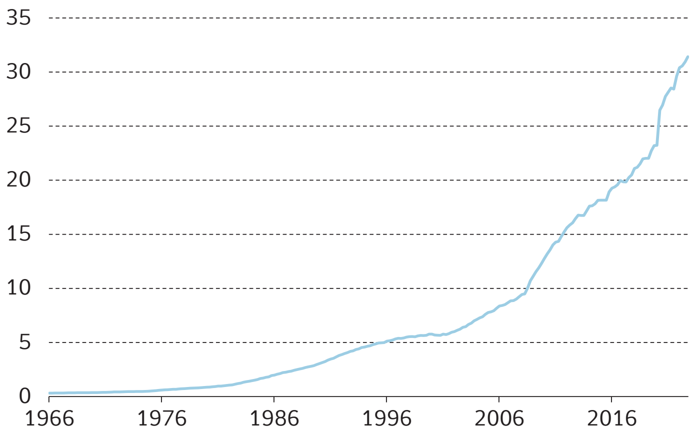
In response to the banking crisis, regulators are considering even stricter measures to strengthen the financial system. Among the most important proposals are higher capital requirements, which will now also increasingly force regional banks to build up higher reserves for possible losses. Stricter stress tests, which simulate severe economic downturns, are also under discussion. In addition, there is a call for greater transparency in risk position disclosure from banks. To minimise systemic risks, the idea of "living wills" is also gaining ground. Here, banks would be required to develop plans for a swift and orderly resolution in the event of insolvency. These measures are aimed at preventing future crises and protecting consumers and the economy.

Basic Trend:
The US debt ceiling dispute

Basic Trend 1:

US government debt in USD trillions

Source: FRED



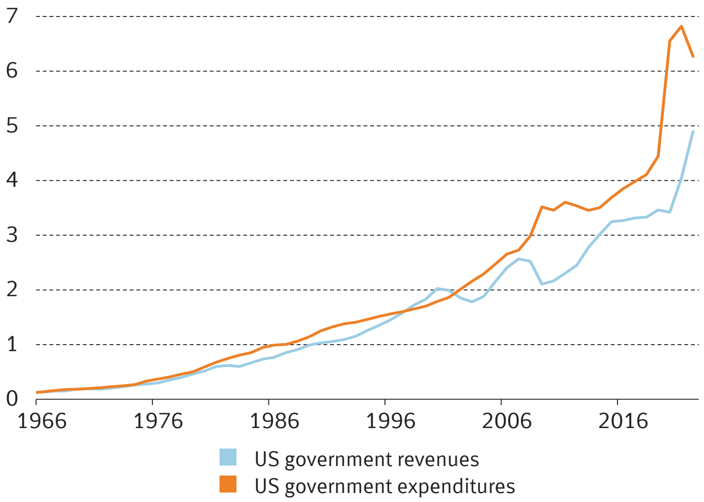
The US debt ceiling

Since 1917, the US debt ceiling has been a longstanding limit set by the US Congress on the amount of government debt the Treasury can issue. Since the US hit the USD 31.4 trillion federal debt limit on January 19th, the Treasury Department has sought to continue servicing debt. The Congress held extended discussions on a potential 79th debt limit increase at the end of May and ultimately agreed to suspend the debt limit until January 1st, 2025: until then, federal debt can continue to exceed the limit. If no agreement had been reached, the US government would have been threatened with default on its obligations. With the status of the US dollar as reserve currency and US government bonds as the world's safest investment, the consequences for the global economy would have been severe.

Basic Trend 2:

USD trillions per year

Source: Congressional Budget Office



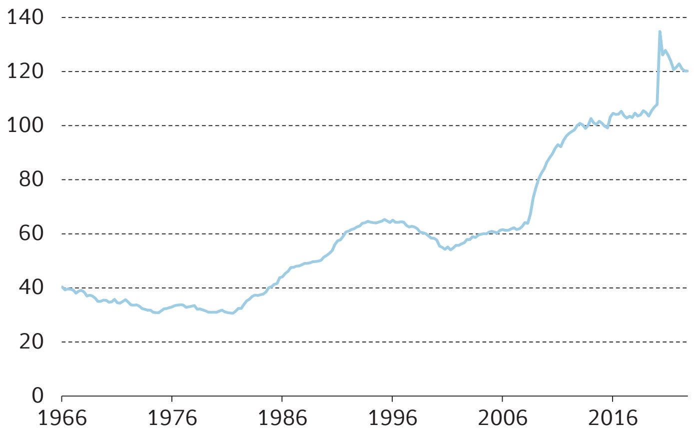
Debt reduction measures

The US debt ratio is currently around 120% of GDP. In order to ease the burden on the national budget, a variety of measures may be considered on both the revenue and the expenditure side. However, both of these measures could negatively affect economic growth and employment. To increase tax revenues, the government could raise income tax rates. The implementation of a wealth tax would also be feasible, as well as the closing of tax loopholes, stricter regulations for tax havens or higher penalties for tax avoidance. Spending cuts could be implemented in various areas such as transfer payments, investments and mandatory or discretionary spending. The new legislation sets a nominal spending cap for 2023, which will be increased by 1% in 2024. The defence budget is exempt.

Basic Trend 3:

US government debt as a percentage of GDP

Source: FRED



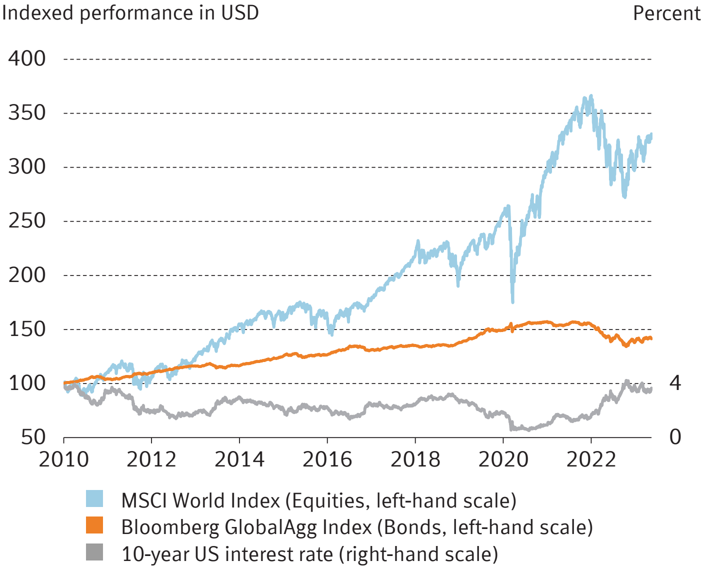
Sovereign debt sustainability

Sovereign debt sustainability refers to the ability to service debt over the long term without getting into financial difficulties. Decisive factors are the ratio of sovereign debt to economic output (GDP), the country's repayment capacity and the interest rates at which it can borrow. Economic growth and inflation are also relevant. High inflation brings uncertainties, but reduces the real debt burden, as debt is usually denominated in nominal amounts. With a high debt burden in a weak economy, debt sustainability often suffers because tax revenues do not cover the required government spending. Consequently, an ideal economic environment for sustainable public finances includes a sound economy, combined with effective fiscal policy and controlled government spending.

Knowledge & Experience: Investment implications

Knowledge & Experience 1:

Indexed performance in USD

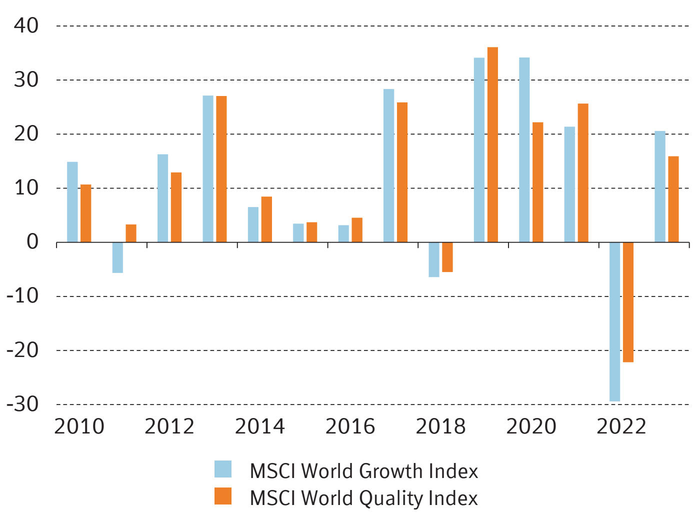


Equities remain more attractive than bonds

As a continuation of our previous Compass issue, we want to focus on investment implications arising from the current economic situation. As a reminder: since 2013, we find ourselves in a secular stagnation, in which the difference between the real interest rate, which is neutral for price stability, and potential economic growth is negative. While real interest rates have risen due to the negative supply shocks of Covid and the Ukraine war, the difference to growth remains negative. In this environment, equities are more attractive than bonds. Potential growth is still large enough to make it worthwhile participating in stock market developments. By contrast, the persisting relatively low real interest rates are reducing the attractiveness of fixed-income bonds.

Knowledge & Experience 2:

Annual performance in USD in percent

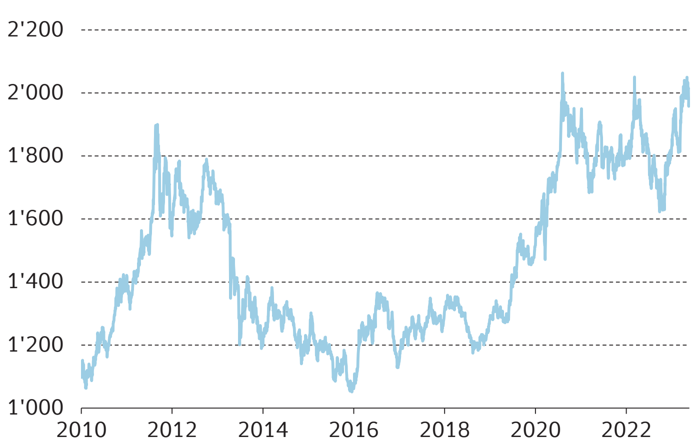


Quality instead of growth

Usually, growth stocks tend to benefit particularly from the negative difference between the real interest rate and potential economic growth. However, since 2022, the difference between growth and interest rate has decreased, which affects the profitability of growth stocks. Within equites, we therefore consider quality stocks as a more appropriate choice for investors in the current environment. Quality companies are characterised by stable cash flows and their stocks are correspondingly less volatile. Such companies exhibit high profitability, healthy balance sheets, and stable dividend yields. In addition, they typically have low debt ratios, which makes them less sensitive to interest rate hikes, providing a further advantage in the current environment.

Knowledge & Experience 3:

Price of gold in USD per ounce



Gold as "safe haven"

In contrast to equities and bonds, the precious metal gold has a different profile. Since gold does not generate cash flows and its value is intrinsic, it tends to react contrary to interest rate movements. If real interest rates continue to rise, demand could shift away from gold in favour of other asset classes. However, since the real interest rate is still at a historically low level, demand for gold as a safe haven is likely to remain unbroken. As the price trend illustrates, the precious metal has recently been at an all-time high. There are many possible reasons for this. The most important reason was probably the increase in central banks' gold reserves. Especially given the geopolitical tensions, many countries appeared to be looking for alternatives to the US dollar. Rising US government debt could further exacerbate this dynamic.

The prices used in our analysis are end-of-period prices. The figures used for our valuation model are estimates referring to dates and therefore carry a risk. These are liable to change without notice. The usage of valuation models does not rule out the risk that fair valuations over a specific investment period cannot be attained. A complex multitude of factors influences price developments. Unforeseeable changes could, for instance, arise from technological innovations, general economic activities, exchange-rate fluctuations or changes in social values. This discussion of valuation methods makes no claim to be complete.

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