

Baer Necessities

July 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

Facebook unveiled a consortium to create an open-source digital currency called Libra, set to bring payments to WhatsApp and Messenger in 2020. This would allow consumers to send money around the world easily and for free.

This does not yet matter for Asset Allocation but it may soon: The FT reported that Facebook "hopes Libra will become a global digital reserve system." The digitization of the financial system is the defining paradigm of the coming decade.

Markets display characteristics of a late-cycle: Growth is slowing, liquidity is tight, and volatility is elevated. Earnings growth declines but low nominal and real rates can support P/E multiples.

Economies & Monetary Policies

Although the US has now broken the previous record (set in 1991 to 2000) by entering its 11th year without a recession, other countries have avoided recessions for far longer. Australia is now in its 28th year without one, while Britain had no recessions for 17 years from 1992 to 2008—and both these economies should be quite recession-prone due to their dependence on speculative property sectors.ⁱ Reversion to the mean is not a reliable reason to see an end to this economic expansion particularly if the Fed eases in July.

The total amount of negative-yielding debt crossed the \$13 trillion mark. Circa 40% of global bonds are now yielding less than 1%.ⁱⁱ Negative sovereign bond yields have reached 30Y in Switzerland and 15Y in Germany and the Netherlands. Outside the Eurozone negative yields are up to 10Y in Japan, Denmark, Finland and Sweden.

This is the environment in which the Fed is lowering rates. A rising inflation rate has become a more likely scenario.

Long Swiss Franc? - Consider that the CHF has historically been the best performing currency during a Fed easing cycle and one of the top three performers during a US recession.ⁱⁱⁱ

The current situation for sovereigns was compared to Prince Rupert's Drop^{iv} ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.^v

Politics

President Trump appears frequently as erratic. Decisions are made hastily. This poses risks investors cannot specifically prepare for. At least, the US President seeks re-election for which he needs a higher stock market and a growing GDP in about 15 months' time.

Equities

Counting down a Fed rate cut means the market is hanging on by a (thin) thread.

Healthcare is a super trend with structural changes in the Western world. In the US, spending has risen from below 10% to 12% and is set to head upward to 17%.^{vi} Biotech is where science merges with IT leading to radical innovation.

The introduction of 5G as the latest iteration of cellular technology is already creating winners and losers, an optimal environment for technology sector specialists.

Fixed Income & Credit

Outstanding junk bonds have reached \$1.23 trillion, more than double the level a decade ago.^{vii}

US credit spreads widened to 132 bps Investment Grade^{viii} and to 464 bps High Yield^{ix}. Corporate debt levels remain at all-time highs, especially if one excludes the 8-10 largest cash rich tech companies. The situation in the US oil & gas sector could lead to bankruptcies and distressed opportunities already this year.

A slowdown in the US could hit direct lending hard. Bond yields in EUR and CHF foster business but present an unattractive risk/reward.

Emerging Markets Currencies & Debt

Bond prices reflect inflationary expectations and the likely responses from central banks. In EM, strong economic growth invariably means higher inflation in some countries.

The MSCI China A shares inclusion is a structural change that naturally attracts foreign money. Despite the run-up this year the sentiment for Chinese equities is bullish.^x

Commodities

Further incidents of the tension between the US and Iran could compel both sides to a spiral of escalation that could see crude shipments interrupted and pushing oil prices sharply higher.

Our bullish stance on gold since the beginning of the year has come true. Supply of physical gold is tight, leading to a gap risk of higher prices. For now, the trend is your friend.

Asset Allocation

In conclusion, we are a lot less bullish but not bearish.

Overweight equities vs. fixed income. Stick to liquid asset classes to stay flexible and nimble without opportunity costs since the premium for lack of liquidity has been eroded anyway.

We are amidst a megatrend of technological disruption. As the world goes digital overweight the disrupters. In sector allocation consider healthcare, biotech and technology.

Roland Eberhard

July 1, 2019^{xi}

ⁱ Anatole Kaletsky, Gavekal Research, June 10, 2019: "Not Such A Dystopian Market"

ⁱⁱ <https://www.marketwatch.com/story/value-of-debt-with-negative-yields-nears-12-trillion-2019-06-18> & <https://www.bloomberg.com/news/articles/2019-06-21/the-world-now-has-13-trillion-of-debt-with-below-zero-yields>

ⁱⁱⁱ JP Morgan, Paul Meggyesi, June 10, 2019: <https://www.bloomberg.com/news/articles/2019-06-10/fed-easing-history-shows-swiss-franc-as-best-bet-jpmorgan-says>

^{iv} Equinox Partners

^v Wikipedia: "Prince Rupert's Drops (also known as Dutch tears) are toughened glass beads created by dripping molten glass into cold water, which causes it to solidify into a tadpole-shaped droplet with a long, thin tail. These droplets are characterized internally by very high residual stresses, which give rise to counter-intuitive properties, such as the ability to withstand a blow from a hammer or a bullet on the bulbous end without breaking, while exhibiting explosive disintegration if the tail end is even slightly damaged. In nature, similar structures are produced under certain conditions in volcanic lava.

The drops are named after Prince Rupert of the Rhine, who brought them to England in 1660, although they were reportedly being produced in the Netherlands earlier in the 17th century and had probably been known to glassmakers for much longer. They were studied as scientific curiosities by the Royal Society and the unravelling of the principles of their unusual properties probably led to the development of the process for the production of toughened glass, patented in 1874."

^{vi} Gavekal Research: "And as America ages, mandatory spending on social security, Medicare and Medicaid will rocket higher. For years, that spending remained below 10% of GDP. Today, it stands at 12%, and in the coming decade, as the chart below shows, it is set to head relentlessly upward to 17%." - The Case Of The Missing Inflation: US Fiscal Policy; Louis Gave; April 29, 2019

^{vii} <https://www.bloomberg.com/news/articles/2019-06-21/the-world-now-has-13-trillion-of-debt-with-below-zero-yields>

^{viii} JPM Investment Grade Index

^{ix} JPM High Yield Index

^x MSCI announced the decision on Feb 28, 2019: China is increased from 5% to 20% in three steps in May, August and November 2019. "On completion of this three-step implementation, there will be 253 Large and 168 Mid Cap China A shares, including 27 ChiNext shares, on a pro forma basis in the MSCI Emerging Markets Index, representing a weight of 3.3% in the pro forma index." see: <https://www.msci.com/documents/10199/43f3ee8b-5182-68d4-a758-2968b4206e54>

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