

# Baer Necessities

December 2019

## Perspectives for Strategic Asset Allocation

### Observations, Markets & News

Markets are stretched but we have not yet arrived at the nadir in rates. The zenith of equity markets will likely be reached when the discount rate rises. Equity markets still offer an attractive earnings yield compared to low interest rates.

Sell in May and go away? – A possible motto for 2020 since the current QE by the Fed runs out in April and the Democratic contender will be known only in about May or late spring.

A weak US dollar and strong Emerging Markets (EM) remain a high likelihood as detailed last month. The Fed aggressively expanding the supply of US dollars is bearish for dollars.

### Economies & Monetary Policies

Markets are caught in a balancing act between strong consumption and weak manufacturing.<sup>i</sup> Growth in global industrial production should turn up over the coming months as a result of further central bank easing. Although the recovery is expected to be shallow, it will add to the service sector's resilience to prolong the economic cycle.

### Politics

We know for certain to face a drawn-out primary season in the battle for the Democratic candidate. Super Tuesday<sup>ii</sup> is March 3 but the decisive date is more likely April 28<sup>iii</sup> even though the last primary election is as late as June 16.<sup>iv</sup> Should Elizabeth Warren win the Democratic nomination then her policies will be seen as equity- and dollar-negative. To be clear though: The odds remain wide open.

Japanification remains the main risk in Europe. Correcting property values are part of such a scenario. This month marks the 30<sup>th</sup> anniversary of the top of the Nikkei 225<sup>v</sup>: The market has since corrected by -40.2%. Put differently, equities would have to rise 67.2% to reach the all-time high again.

Let's hope for an end to the intra-Asian trade war between Japan and South Korea as the regional supply chain is being interrupted.

### Equities

We remain positive on equities with a preference for US stocks, as we have been since January.

Themes and sectors we like include Ageing Population, Digital or Cyber Security, Digitization, Automation & Robotics, Artificial Intelligence & Big Data, Water, and Biotechnology.

Note though: Sectors with wider dispersion require active managers.

### Fixed Income & Credit

Global government bonds are expensive. Yields on so many sovereign bonds do not reflect the inherent risks.<sup>vi</sup> The current

situation for sovereigns was compared to Prince Rupert's Drop<sup>vii</sup> ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.<sup>viii</sup>

Global investment grade (IG) bonds are also expensive. For instance, more than 40% of the EUR corporate IG universe delivers negative yields.<sup>ix</sup> For US IG spreads remain supported by "the search for yield" at least until supply pressure returns.

Remain underweight credit and expect a rising default rate at some point, particularly among high yielding debt.

### Emerging Markets Currencies & Debt

Differentiation among EM is key in all asset classes. Favor countries that are pursuing integrationist policies. Active strategies should outperform passive ETF's.

### Commodities

Precious Metals remain a complementary asset class to equities. The small negative carry from holding physical gold is still better than the negative sovereign yields.

We remain bullish on Precious Metals as we have been since January because of an overall supply/demand imbalance. Gold could be the harbinger of bad news in the sovereign debt markets. See comments by the Dutch central bank below.<sup>x</sup>

Political progress on trade and a recovery in manufacturing are expected to be positive for cyclical commodities. We have no strong view on oil, natural gas or European power.

### Asset Allocation

When markets are at record highs and geopolitical uncertainty is increasing one becomes more conservative by buying higher quality assets. With yields at rock bottom equities with steady earnings and high free cash flows become attractive. The yield of future dividends provides a floor to the downside.

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.

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

Consider adding tail hedges provided the mandate permits it. Alternatively, add active strategies with uncorrelated returns and convexity.

Hold Precious Metals.

Roland Eberhard

December 2, 2019<sup>xi</sup>

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<sup>i</sup> The US saw 3Q19 GDP revised up by 20bp to 2.1% last week, with the bulk of that coming from slightly better consumption, a somewhat smaller drag from investment, and a more positive contribution from inventories. October durable goods report was strong; better shipments will support 4Q business investment in GDP tracking, and better orders indicate some momentum on a forward-looking basis.

<sup>ii</sup> Super Tuesday (March 3): Alabama, Arkansas, California, Colorado, Massachusetts, Minnesota, North Carolina, Oklahoma, Tennessee, Texas, Utah, Vermont and Virginia primaries

<sup>iii</sup> April 28: Connecticut, Delaware, Maryland, Pennsylvania and Rhode Island primaries

<sup>iv</sup> June 2: Montana, New Jersey, New Mexico and South Dakota primaries

June 7: Puerto Rico Democratic primary

June 16: Washington, D.C., Democratic primary

<sup>v</sup> The average hit its all-time high on 29 December 1989, during the peak of the Japanese asset price bubble, when it reached an intraday high of 38,957.44, before closing at 38,915.87, having grown sixfold during the decade. (Source: Wikipedia)

<sup>vi</sup> Bloomberg published a thought-provoking article on November 13, 2019 (Brandon Kochkodin, Bloomberg, 'LTCM Co-Founder Finds Infinite Value in Bonds on Negative Rates'). Quote: "Perhaps more realistically, consider Austria's 100-year bond, one of the closest approximations to a modern-day sovereign perpetual bond out there.

The same bond-pricing calculator produces a price of 173 euros when you use its current yield of 0.95% as the discount rate, an indication the market expects interest rates to average about 1% over the remaining 98 or so years of the bond's life.

But assume the discount rate falls to -0.5% and then stays there, then the bond's expected price shoots past 400 euros."

<sup>vii</sup> Equinox Partners

<sup>viii</sup> 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."

<sup>ix</sup> Source: Factset, Bloomberg, Credit Suisse  
Last data point: 29.11.2019

<sup>x</sup> The Dutch Central Bank, known as De Nederlandsche Bank (DNB), wrote on October 15, 2019 that gold would be indispensable in the event of a fiat meltdown. The Central Bank writes: "Gold is the perfect piggy bank – it's the anchor of trust for the financial system. If the system collapses, the gold stock can serve as a basis to build it up again. Gold bolsters confidence in the stability of the central bank's balance sheet and creates a sense of security."

see also:

<https://www.dnb.nl/en/payments/goud/index.jsp#>

<https://www.dnb.nl/en/news/dnb-publications/financial-stability-report/dnb385947.jsp>

<https://www.dnb.nl/en/news/news-and-archive/Nieuws2019/dnb385962.jsp>

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