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Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

The Fed's indication to keep rates on hold well into 2020 is clearly bullish for economies and markets. Data releases in April have confirmed a rebound in economic activity. Global equities rose with US stocks closing at or near record highs.

Two major risks are rising inflation and politics as discussed below. The return of inflation could be more of a risk than presently discounted. But, low inflation along with strong global economic activity means that we remain in a bull market.

The cyclical upswing should lead to rising asset values of equities but also of some commodities. The trend will continue until growth disappoints or inflation rises.

Economies & Monetary Policies

The pressures usually leading to recessions are still absent: Solid private savings, no visible over-investments in any particular sector, and sound bank balance sheets lead us to expect more years of growth. This is even true for Europe where final domestic demand is around trend of 1.5% with a supportive monetary policy, declining fiscal headwinds with politics shifting to fiscal expansion, and recapitalized bank balance sheets.

There are no signs of rising inflation but two major factors to watch are wage inflation and rising oil prices.

Still, the current situation for sovereigns was compared to Prince Rupert's Drop[i] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[ii]

Politics

Biggest political risk is the US tariff policy that could lead to actual trade wars. The risks seem a bit lower than they used to because Trump looks to be already in pre-2020 election mode when he is going to need a strong economy and stock market.

Equities

The US equity market is volatile and fully-priced. In comparison, we favor European equities. European volatility is unusually cheap, both absolutely and relatively. Euro Stoxx 50 one-month implied vol hit a record low last week. Looking at dividend yields, European equities are also cheap compared to US stocks.

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%.[iii]

We remain bullish biotech where infotech is merging with medical science leading to drastic changes. Price/sales ratios remain close to historic lows. M&A is picking up, too.

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

Fixed Income & Credit

Low yields reflect low inflation expectations. Better economic data could lift bond yields but limited due to presumed monetary policy responses. Corporate debt levels remain at all-time highs (especially if you exclude the 8-10 largest cash rich tech companies).

Bond yields in EUR and CHF foster business but present an unattractive risk/reward to investors.

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.[iv]

Commodities

Commodity traders report tight markets. There remains upside risk in oil prices.

Spot prices for oil have risen sharply this year. Oil markets surged after the announcement that the US will eliminate waivers for nations importing crude oil from Iran. While forward curves trend lower a further rise would lead to inflationary pressures. Oil importing countries such as India and Indonesia have seen their equity markets correct for precisely this reason.

Asset Allocation

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.

Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

Roland Eberhard

May 1, 2019[v]

[i] Equinox Partners

[ii] 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.”

[iii] 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

[iv] 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