

Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

In God we trust, but everyone else please bring data: A clear trend is towards digitization. To keep an edge one has to use algos to support what remains a discretionary investment process. In turn, this has a key implication because the observer effectⁱ tends to kick in. As more market participants apply a somewhat systematic approach the market itself adapts. These are factors to keep in mind.

Economies & Monetary Policies

Economic growth is real but softening. Investors are more concerned about growth than about inflation. The US treasury yield curve inverted as one of the most reliable warnings of looming recession with 3mth bills at 2.3% and 10yrs at 2.1%. Minor disappointments in activity and inflation could be sufficient for preventive rate cuts.

In Europe with rates in negative territory the central banking era is ending, replaced by politics.

In Turkey Erdogan's policies have ramifications for European growth. In Germany, the slowdown in GDP growth can be explained by Turkey and by Brexit. Neither of these two factors is likely to get better anytime soon.

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

Politics

Biggest political risk is the US tariff policy. No country is immune from a capricious US foreign policy.

Modeling trade tariffs is in fact complex. How a nation's currency adjusts to new tariffs, how corporate profit margins shrink and how consumers react is difficult to predict. This unpredictability causes market jitters. Take rare earth metal exports as an example: Once Apple announces the product launches for November 2019 China has a mighty power over Apple and their input costs into 2020. How can a shareholder model that?

Equities

The US equity market is volatile and fully-priced. Looking at dividend yields, European equities are attractive.

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%.^{iv}

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.

Fixed Income & Credit

US credit spreads blew out to 144 bps Investment Grade and to 467 bps High Yield. 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 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.^v

Commodities

Many oil & gas producers are not in good shape. Despite production growth of about 16% in oil alone this year^{vi} it is economically not viable. Economically, price should equal marginal cost. But that's not the case now.

The roll yield of the S&P GSCI index has turned positive, meaning there is positive carry in holding the GSCI basket (energy, agriculture, livestock and metals). This could mark a floor in the index level as it is likely to attract buyers

Asset Allocation

In conclusion, we are a lot less bullish but not bearish. Positives remain a slush of liquidity and a US President who seeks re-election for which he needs a higher stock market and a growing GDP in about 15 months' time. But risks are rising.

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

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ⁱ Also referred to as the Heisenberg uncertainty principle where the mere observation of a phenomenon inevitably changes that phenomenon. Put differently, the instrument that measures something influences the thing it measures.

ⁱⁱ Equinox Partners

ⁱⁱⁱ 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."

^{iv} 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

^v 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>

^{vi} <https://oilprice.com/Energy/Crude-Oil/US-Shale-Oil-Production-Set-To-Grow-16-This-Year.html>

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