

Baer Necessities

December 2020

Perspectives for Strategic Asset Allocation

Observations, Markets & News

Markets anticipate that the pandemic morphs into local epidemics. With several vaccinations announced, there is light at the end of the tunnel. Different providers filed for emergency use authorization for their Covid-19 vaccines. These vaccines roll out in December and will be widely available in January and February next year. In short, markets anticipate that we live in a world not free of Covid-19 but at least a world where the risks of an economic shutdown are minimal. The worst is behind us. Indeed, this favorable situation is not yet reflected here and now. Lockdowns seem to be with us into the new year. Notwithstanding, let us remember Thomas Fuller's words of hope: "It is always darkest just before the Day dawneth."ⁱ

Politics, Economies & Monetary Policies

The election of Joe Biden has strengthened our case for ESG. Europe was the first to declare the goal of becoming climate-neutral by 2050. Japan pledged to become carbon neutral by 2050 under Yoshihide Suga, Japan's new Prime Minister. With the US part of the Paris Agreement, the stage is set for massive investments.

The winners in green energy and transport will enjoy exponential growth. Most of us are under-invested in renewable energy, electric transportation and related sectors that anticipate the future. We are in the early stages of a long-term trend in ESG: Environment, Social and Governance.ⁱⁱ

There is increasing hope that inflation might rise in 2021. Simply put, aging leads to fewer producers and more consumers, which makes prices go up. Aging in Japan and Europe has been embedded in a world with growing labor forces in Emerging Markets. The change is that in this new decade, China starts aging rapidly, too.

Another reason given is that there will be stronger business activity next year with the hopes of an effective vaccine. Consequently, higher long-term bond yields will lead to a steepening US yield curve. There is undoubtedly greater potential for the yield curve to steepen than to flatten.

Equities

Small caps in Europe and in the US need a firm place in asset allocation. Smaller companies benefit disproportionately from growth and will be less harmed by higher yields.

The Dow crossed above 30'000 for the first time. CNN's Fear & Greed Index hit 92 – close to a record high, a sign of most extreme greed.ⁱⁱⁱ With a bright US growth outlook, we are in the bullish camp. Still, it pays to be cautious even in the best of times. We suggest adding long vol tail hedges.

Fixed Income & Credit

China borrowed at negative interest rates for the first time. The offering attracted final orders of about \$18.9 billion for the \$4.7 billion worth of bonds on offer and included 5Y debt priced with a yield of -0.152%. China also sold 10Y and 15Y bonds with yields below 1%.^{iv} Our bullish case for Chinese sovereign and corporate bonds remains. RMB is a strong currency with further yield pressure.

Credit spreads should narrow on the overall improvement in the global economic outlook and continued asset purchases by the central bank. Yet, fundamentals will play a more significant role. The rise in US zombie firms is concerning.^v

With global debt to GDP as stretched as it has ever been, sovereign bonds, investment grade credit, and junk bonds collectively are the most over-valued in history: What is perceived as a robust and balanced system one day could blow up the next just like Prince Rupert's Drop ("larme de verre").^{vi}

Commodities

Industrial material such as copper have soared with the news around Covid-19. While this trend might continue into the new year, we should also be leery of excess.

The price of gold might pause until real inflation numbers start rising. Our bullish investment thesis began in January 2019. Nearly two years later, we are skeptical. Longer-term, the demand overhang persists. But in a world where economic growth will surprise to the upside, there are other opportunities.

Alternatives

Despite the good economic outlook, US defaults are likely to rise further.^{vii} Distressed investing becomes attractive again.

Relative value strategies are an apt alternative to bonds.

Asset Allocation

We have a high conviction that 2021 will start as a year of economic recovery, coupled with still-low interest rates to support equities and bonds. We overweigh China and Emerging Markets. In mature markets, we like small caps.

Diversification across different risk factors remains relevant, especially to maintain some risk for the higher inflation scenario. Alternative investments may help in this regard.

We prefer equities over bonds. We regard the Swiss Franc as an asset class. Commodities belong in every portfolio. If permitted by the mandate, use convex long vol strategies.

Roland Eberhard
December 1, 2020^{viii}

ⁱ Thomas Fuller, A Pisgah Sight Of Palestine And The Confines Thereof: With The History Of The Old And New Testament Acted Thereon (1650)

ⁱⁱ The term "ESG" has established itself as the standard for sustainable investments. The three letters describe three sustainability-related areas of responsibility of companies:

- 1) The "E" for Environment stands e.g., for environmental pollution or hazard, greenhouse gas emissions, or energy efficiency issues.
- 2) The "S" for Social includes aspects such as occupational health and safety, diversity, or social commitment (corporate social responsibility).
- 3) The "G" for Governance means sustainable corporate management. These include topics such as corporate values or management and control processes (corporate governance).

Various sustainability ratings are based on the analysis of these criteria. A universal standard is not yet developed.

ⁱⁱⁱ CNN's Fear & Greed Index is compiled by how far each of the following seven indicators have veered from their average (<https://money.cnn.com/data/fear-and-greed/>):

1. Stock Price Momentum: The S&P 500 (SPX) versus its 125-day moving average
2. Stock Price Strength: The number of stocks hitting 52-week highs and lows on the New York Stock Exchange
3. Stock Price Breadth: The volume of shares trading in stocks on the rise versus those declining.
4. Put and Call Options: The put/call ratio, which compares the trading volume of bullish call options relative to the trading volume of bearish put options
5. Junk Bond Demand: The spread between yields on investment grade bonds and junk bonds
6. Market Volatility: The VIX, which measures volatility
7. Safe Haven Demand: The difference in returns for stocks versus Treasuries

^{iv} See also: <https://www.reuters.com/article/china-markets-bonds/update-4-china-set-to-sell-its-first-negative-yielding-government-bond-idUSL1N2I40H1> or <https://www.scmp.com/business/banking-finance/article/3110450/china-sells-first-sovereign-bond-negative-interest-rate>

^v Zombie firms are those without enough earnings to service their debt and thus must borrow more money or else go under. While zombie companies are more commonly associated with 1990's Japan, post-crisis Europe, or even China in recent years, their ranks in the US have been increasing for over a decade, fueled in part by years of ultra-loose monetary policy. See also: <https://www.bloombergquint.com/business/america-s-zombie-companies-have-racked-up-1-4-trillion-of-debt>

There are now 527 of these in the Russell index (including Boeing, Carnival, Delta Air Lines, Exxon Mobil, Macy's), with a collective \$1.36 trillion in debt, dwarfing prior levels.

^{vi} 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."

^{vii} Hotel loans are particularly vulnerable: "80% Of New York Hotels On Verge Of Default" <https://www.ft.com/content/409e25fb-c18d-4a0c-a21b-3b0ea790a6f2>

The retail sector is seriously hurt, leading to higher defaults among mortgages on US malls. These are just two examples of plenty of other industries suffering from Covid-19 related economic shutdowns.

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