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INPUT FOR STRATEGIC ASSET ALLOCATION

JANUARY 2019

PERSPECTIVES (3-6 MONTHS)

Observations, Markets & News

Leadership matters. When leadership fails, such as it did at 10 Downing Street or in the White House, uncertainty reigns, the worst state for financial markets. So much for December.

Beware of the illusion of certainty: 2018 was a year in which volatility forced its way back. Geopolitics took center stage. Consensus shifted from an idea of global synchronous growth with a healthy rise in rates, to one marked by fears over growth contraction and potential central bank missteps.

As investors we must continually seek to define a wide range of possible outcomes. Successful speculators speak in probabilities of one thing over another. Not one dares to pound the table and state something with absolute certainty. Our job is to figure out what others will do because of their political and financial orientation, in a world that is unknowable, forever changing, and then make money with that.

The market regime in 2019 will likely be significantly different than in 2018. To form an accurate outlook guessing monetary policy and estimating inflation rates are the key variables.

Economies & Monetary Policies

Central Banks started the path back to 'normal', a financial environment outside their direct influence. They believed they would have choices. But the markets sent different signals. In Europe, years of asset purchases and negative rates failed to produce an expansion sufficiently robust to allow for policy normalization.

The transition from quantitative easing to quantitative tightening is likely as painful as a recession to the financial markets, even if it is not to the real economy. But to investors, that distinction will feel irrelevant.

QE has done something much more damaging than Central Banks could have imagined. It changed the very nature of the market, destroying the diversity of the market ecosystem, and making it incredibly vulnerable to the smallest change in the macro environment

Economic conditions are fine, not great, but fine. The lower oil price also helps supporting growth.

Property prices in large city centers could be next: There are way too many cranes in Manhattan, London, Hong Kong and even in 2nd tier towns like Frankfurt or Berlin, even Paris.

In Switzerland the real estate boom is particularly pronounced due to the negative rates. Swiss pension funds make decisions on property yields as if negative rates are going to stay with us for a decade or more, an extremely unlikely scenario.

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] Q4 2018 was not yet the Dutch tears we reference though.

Politics

In France, austerity is dead. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending. This is the path Europe is on.

In America, General Mattis' departure as Secretary of Defense is a worrying signal, increasing gap risks in geopolitics.

Equities

Interest rate-sensitive sectors should be avoided as long as rates keep on being raised.

If we are right about the normalization of monetary policy and consequently to a return to ordinary market cycles then this is a time for stock pickers, long and short.

Stocks face a dichotomy between good news from corporate earnings and bad news from monetary policy. Equity prices are a three parts equation of discounted future earnings, interest rates and risk premiums. Risk premiums in turn are largely dependent on the degree of uncertainty. While major economies are still growing the growth rate is slowing and USD rates are rising, respectively the Fed is tightening.

Japanese equities offer an attractive risk/return: The TOPIX is priced at a multi-year low in P/E and supported by an accommodative BOJ and a cheap Yen.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating. M&A is likely to pick up, too.

Fixed Income

The top of the debt cycle could become a predominant theme.

Distressed, a theme for H2 2019? - Credit long/short managers are particularly enthusiastic. 2019 marks the beginning of a two- to four-year period of re-financings in the US corporate bond market. The now higher rates and a slower economic growth are enough for some companies to fall into technical default or for investment grade bonds to be re-priced as junk.

As this unfolds distressed investing plus fundamental bond picking, long and short, could be an attractive place to be.

Emerging Markets Currencies & Debt

China is at the end of its economic cycle with significant excesses in the credit market. Total debt is about 260% of GDP.[iii] Most of the new credit has been used to finance fixed asset investment, which lead to overcapacity. The rate of return on assets in the state-owned corporate sector has fallen below borrowing costs. 22% of apartments are vacant.[iv] There are 50 ghost cities and construction continues.[v] Authorities need to strike a fine balance between unwinding the credit bubble and restructuring the economy and preventing a destabilizing economic and financial crisis.

Commodities

Consensus among oil traders seems to be that supply outstrips demand. US shale production growth could have peaked.

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.

Asset Allocation

Overweight liquid asset classes to stay flexible.

Underweight fixed income and credit.

Look for diversifying assets and / or strategies. Implied volatility is likely to move higher before long.

Tail Hedges: The gap risk is high. This is the time to decide on a budget for tail hedges, always long vol and with an attractive risk/return ratio, albeit with a low probability of success. Call us to discuss individual tail hedge ideas. [vi]

We wish you a happy, healthy & successful 2019!

Roland Eberhard

January 3, 2019

[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] Karya November 2018 Newsletter, December 1, 2018

[iv] Bloomberg, November 8, 2018, 'A Fifth of China's Homes Are Empty. That's 50 Million Apartments'; https://www.bloomberg.com/news/articles/2018-11-08/a-fifth-of-china-s-homes-are-empty-that-s-50-million-apartments

[v] Australian Broadcasting Corporation ABC News, June 26, 2018, ' China's eerie ghost cities a 'symptom' of the country's economic troubles and housing bubble'; https://www.abc.net.au/news/2018-06-27/china-ghost-cities-show-growth-driven-by-debt/9912186

[vi] Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen. The CHF offers trading opportunities, too.