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The Swiss Merchant Bank

BARE NECESSITIES

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PERSPECTIVES FOR STRATEGIC ASSET ALLOCATION

Observations, Markets & News

Conviction levels are low. Traders run small amounts of risk and focus on the short-term. This is not the market to have long-term views. The longer the uncertainty about global economic growth persists, the sooner the often-voiced weakness of the economy becomes a self-fulfilling prophecy. In about one to two months, we will have clarity on Brexit and the US-China Trade War[i]. Now that the Fed's Quantitative Tightening is on hold this could be positive for risk assets.

Key markets to monitor are the US dollar, the 10-year US treasury yield, US corporate spreads, and the price of oil. It is the interactions of these prices that decide the majority of other prices in the world's economic and financial system.

Consider spending money on insurance: Brexit and US tariffs[ii] are binary events that could cause sharp falls in asset prices. Eventually, this bubble has to delever but this time credit is not only on banks' balance sheets but also in high yield markets.

Economies & Monetary Policies

Now that the Fed pauses monetary policy is favorable for the risk / return equation. Still, we remain overall in an environment of tightening liquidity conditions amidst higher real rates.

We do not expect the ECB to be as quick as the Fed to switch policy stance if the euro region's slowdown worsens.[iii] Despite a recession in Italy and a significant loss of economic momentum in Germany, the ECB isn't showing much urgency to reverse course on a stimulus-withdrawal path that was originally supposed to include an interest-rate increase.

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

Politics

A notable shift from monetary policy to fiscal is under way in North America and in Europe. A selfish disregard for the future has attracted the ire of voters and demonstrators, a trend that is likely to continue in this year's elections.

In France, austerity is dead in that the Government will not risk further discontent. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending. This is the path Europe is on.

Equities

For US equities we expect lower returns with wider dispersions and higher volatility. Technology, while still an incredible powerful agent of change, faces more valuation and regulatory headwinds than in the past. Cloud companies seem to grow strong independent of economic cycles.

As of now, the entire Japanese market appears undervalued. For example, the P/E of the Nikkei index has now fallen to only 11x, while the JASDAQ P/E is 12x. Meanwhile, Japan remains the only country in the world still continuing with a policy of qualitative and quantitative easing. The yield on the 10-year JGB remains around 0%. In other words, the equity risk premium is now about 8-9%, making Japan one of the most undervalued markets in the world.

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

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

Being long US Treasuries seems an attractive risk / reward as long as the Fed's tightening is on hold. In fact, leading indicators like housing and autos predict a further weakening of the US economy in which case rates could actually drop, a scenario neither expected or priced in.

USD denominated bond yields appear to have peaked for the medium term and valuations are now back at reasonable levels. 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

A dovish Fed implies a weak USD and an outperformance of Emerging Market assets.

China is at the end of its economic cycle with significant excesses in the credit market. Total debt is about 260% of GDP.[vi] 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.[vii] There are 50 ghost cities and construction continues.[viii] 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.

Gold should do well with a possible demand overhang.

Asset Allocation

Overweight liquid asset classes to stay flexible and nimble.

Overweight equities since corporate bonds are unattractive in their risk / return and other asset classes are lagging. Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

The combination of easier money and a weaker dollar support global credit conditions in the short-term. Later in the year, it is likely that a continued accumulation of inflationary pressures, combined with easing in China, could force the Fed's hand into resuming the tightening campaign.

Shorter-term, equity vol is likely to subside while macro vol (rates and FX) increases. This should be positive for Relative Value strategies.

Roland Eberhard

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[i] A further escalation of the US-China Trade War is unlikely. Still, the US decision to press criminal charges against China's Huawei in late February suggests that relations are not exactly amicable.

[ii] This is a reference not only to the US-China Trade War but to the US Section 232 investigation that will wrap up February 17, which could result in steep tariffs on European cars and car parts. As it seems Trump wants to keep a 25% tariff on light trucks and SUV's.

[iii] Eurozone growth has slowed from 2.8% a year ago to 1.2% in Q4 2018.

[iv] Equinox Partners

[v] 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."

[vi] Karya November 2018 Newsletter, December 1, 2018

[vii] 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

[viii] 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