

Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

Even with central banks on pause, the widespread economic slowdown in the developed world is likely to continue.

Market direction in Q1 2019 has so far been the opposite of Q4 2018. As passive money and computer driven trading strategies are becoming a bigger proportion of market trading volumes, the frequency of sharp momentum reversals will grow.

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 are binary events that could cause sharp falls in asset prices.

Economies & Monetary Policies

Global inflation remains subdued. Authorities will be ever more prone to use monetary and fiscal tools to dampen volatility. Elevated debt levels make corporations and households increasingly sensitive to changes in interest rates and thus it is not a surprise that credit creation has stalled. Credit growth is now roughly 0% across the developed world.

US economic growth slowed moderately in Q4 2018 to an annualized GDP growth of 2.6%. Existing home sales fell 1.2% in January to a 3-year low. Jobless claims are rising to now 225'000.

Economic slowdown across the developed world outside the US likely represents a bullish scenario for the USD. Historically, easing financial conditions in the developed world relative to the US have corresponded with weakening FX rates vs. the USD.

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

Politics

A notable shift from monetary policy to fiscal is under way in North America and in Europe. If a 'no deal' Brexit scenario is avoided the UK economy will assuredly get a boost.

In Europe expect a fiscal policy in the form of stimulus programs, tax cuts or subsidies as gifts for the voters. In France, austerity is dead as Emmanuel Macron faces the yellow vests. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending.

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.

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.

The entire Japanese market appears undervalued. The end of the financial year could see a re-rating starting in April. 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.

Fixed Income

Recent economic deterioration will be sufficient to ensure that G4 central banks will be on hold in 2019, with a higher risk of easing than tightening. The implication of this view is that rates volatility should continue to fall creating a positive environment for high yielding bond positions.

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.

Emerging Markets Currencies & Debt

The macroeconomic backdrop for emerging markets (EM) remains healthy. Valuations are attractive, and currencies are undervalued. After a strong start to 2019 EM assets are likely to continue recovering.

Broadly speaking, EM sovereign credit remains in a sweet spot offering good valuations and carry.

As always, there are outliers with political risk such as Brazil. Argentina is an asymmetric opportunity into this year's election.

Commodities

Oil looks also to be in an upward trending market. OPEC's firm language reiterated its commitment to production cuts.

Gold should do well with a possible demand overhang.

Palladium hit a record high. Metals are in a prolonged supply deficit. In metals mining capital expenditure fell to \$38bn in 2018 from a peak of \$77bn in 2012. This has led to shrinking stockpiles for copper, zinc and nickel.

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.

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

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March 1, 2019ⁱⁱⁱ

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 Disclaimer: This document is for information purposes only. It constitutes neither an offer nor a recommendation to purchase, hold or sell financial instruments or banking services, and does not release the recipient from carrying out their own assessment. The recipient is recommended in particular to check the information in terms of its compatibility with their own circumstances and its legal, regulatory, tax and other consequences, possibly on the advice of a consultant. The data and information contained

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