mbaer
The Swiss Merchant Bank

Baer Necessities

April 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News
What a start to the year: Global stocks up 11% (best since 2010), the S&P500 up 13% (best since 2009), China's CSI 300 up 29% (best since 2014)![i]

Fundamentals have clearly turned weaker. Equities rallied because of a change of monetary policies and fiscal stimulus. Financial markets have become riskier in that less liquidity drives prices, historically a precursor to large market declines.[ii]

Economies & Monetary Policies
Generally speaking, global data continued to deteriorate, but at a decelerating rate. The big question is the magnitude of the economic slowdown that the US will face and the impacts of this on the rest of the world and risk assets in general.

Several reserve banks have made subtle but important changes to their commentary which is bullish and highlights that the path to more normal rates of interest will not be easy or soon. Are central banks at the end of their wisdom?

The risk reward for bears is now strongly in their favor. In the past eight years or so we have seen a bull market based on stimulus from central banks and economic growth. Macro data has now turned, and central banks have realized that tightening via either higher rates or balance sheet reduction is not an option.

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

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

Equities
As passive money and computer driven trading strategies are becoming a bigger proportion of market trading volumes, we expect the frequency of sharp momentum reversals to grow. Yet, it does provide buying and selling opportunities for fundamental investors.

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 with the psychological boost of the start of 'Reiwa', the new imperial period.

Fixed Income & Credit
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.

Corporate debt levels are at all-time highs (especially if you exclude the largest cash rich tech companies). Expect default rates to rise as we move forward in time towards the heavy maturity wall in 2020-2021.

Emerging Markets Currencies & Debt
The macroeconomic backdrop for emerging markets (EM) remains healthy. Valuations are attractive, and currencies are undervalued.

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. Turkey created a liquidity squeeze in the offshore lira market to curtail currency shorting with potentially devastating effects. Specifically, it will deter international investors who will be asked to refinance some $177 billion of foreign currency debt coming due over the next year.

Commodities
US shale oil production has been hugely positive for US economic growth with the added benefit of lowering the cost of energy. But the end of the cycle is nearing. Share price performance of shale companies is beginning to lag traditional oil drillers.

Gold should do well with a possible demand overhang. Metals are in a prolonged supply deficit.

Asset Allocation
Overweight liquid asset classes to stay flexible and nimble.

Central Bank policy broadly speaking is positive for long-term assets including equities and bonds. But, it is hard to get excited about bonds at current yields, so we favor equities, both in the US and abroad. Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

We are amidst a megatrend of technological disruption. As the world goes digital overweight the disrupters.

Underweight financials: Credit growth is tepid and Asset Liability Management at low or negative rates is a headwind for profitability.

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

Consider spending money on insurance to protect against binary events that could cause sharp falls in asset prices.

Roland Eberhard
April 1, 2019[v]

[i] The longest bull market in US history celebrated its 10th anniversary on March 9, 2019. Since the S&P 500 bottomed out at 676.53 on March 9, 2009 it has more than quadrupled.

[ii] On the S&P 500 futures contract, order book size and trade size relative to market cap have come down by more than 70% in the last two years.

[iii] Equinox Partners

[iv] 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."