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Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

Zombie companies[i] in Trump's America are increasingly a headache. Low and declining real interest rates in the US have allowed companies to carry higher debt loads. The growing universe of zombie companies is yet another example of credit investors' willingness to sacrifice security for yield. When the earnings cycle turns, expect a spike in credit defaults.

The most likely scenario is for an extension of the growth cycle. There is support to stabilize global growth from solid US domestic demand, accommodative central bank policy and the Chinese reflation effort. The data so far suggest that labor force trends remain strong and personal income continues to rise. Headwinds are tariffs and Trump's policy more broadly.

Besides, there are no signs of the typical end of cycle excesses. Longer term, this environment is supportive for risk assets. However, short term the US equity market in particular feels similar to Q4 of last year.

Economies & Monetary Policies

New home sales in the USA jumped 7.1% MoM in August, a sign that lower mortgage rates are enticing home buyers back into the housing market, which should support the US economy and the stock market.

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

Politics

Nationalism and populism of various kinds are on the rise resulting in a reversal of the globalization process, a headwind for trade. Brexit continues to be center stage during October. Expect volatility to remain elevated.

Equities

We just witnessed the largest momentum collapse in a decade, a monumental shift in fund flows and stock preferences.

When the dividends of a company's stock yield higher than the corporate bonds of the very same company it makes logically sense to own the equity rather than the debt. This is a convincing reason to purchase value stocks. This arbitrage remains possible until either the share prices rise or the bonds sell off. With the Fed lowering rates we bet more on the first than the latter. See footnote for examples.[iv]

Monetary stimulus was only required because of the somewhat negative economic outlook, which makes equities of companies less attractive that depend on the growth cycle.

Consider overweighting mid caps. These are naturally overlooked, offer greater upside potential than large caps and still less risk than small caps.

Themes and sectors we like include Ageing Population, Digital or Cyber Security, Digitization, Automation & Robotics, Artificial Intelligence & Big Data, Water, and Biotechnology.

Fixed Income & Credit

Remain underweight and expect a rising default rate, particularly among high yielding debt.

A staggering $17 trillion, estimated to be 30% of all investment-grade fixed income securities globally, trade at a negative yield.[v] Held to maturity these securities guarantee a loss. We are forced to look for positive yields elsewhere such as credit, equities, real and private assets. Prices have held up well despite weakening growth and trade and geopolitical tensions.

Emerging Markets Currencies & Debt

Differentiation among EM is key in all asset classes. Favor countries that are pursuing integrationist policies.

The US-China trade war which has set in motion an unstoppable economic transformation. Events in Hong Kong could herald a change of paradigm, too. For both it is too early to tell which way we will be heading.

Commodities

Gold rose on safe-haven demand, while palladium soared to a new all-time peak amid short supply of the auto-catalyst metal.

With bonds yielding zero equities are made to wear the brunt of return expectations in any portfolio. That's a heavy burden to carry for such a flicker asset class. Precious Metals are a natural complementary asset class.

Carbon prices in Europe and coal prices globally look like an interesting trade opportunity.

Asset Allocation

Geopolitical and macro uncertainties create opportunities for agile speculators investing long and short. This is a time to add active strategies with uncorrelated returns and convexity.

Overweight equities vs. fixed income. Stick to liquid asset classes to stay flexible and nimble without opportunity costs since the premium for lack of liquidity has been eroded.

We are amidst a megatrend of technological disruption. As the world goes digital overweight the disrupters. In sector allocation consider healthcare, biotech and technology.

Hold Precious Metals.

Roland Eberhard

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[i] Zombie companies are defined as those with an EBIT/interest expense ratios below 1. According to data published by Arbor Data Science (Arbor Research & Trading, LLC), the number of Zombie companies in the US is growing, and now rests at 18%. See also: 'Why 'Zombie' Companies Are on the Rise—and Could Pose a Threat to the U.S. Economy', Chris Taylor, Fortune Magazine, September 2, 2019, https://fortune.com/2019/09/02/why-zombie-companies-are-on-the-rise-and-could-pose-a-threat-to-the-u-s-economy/

[ii] Equinox Partners

[iii] 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."

[iv] As of yesterday, these are the dividend yields vs. yields of the company's debt with approximately five years maturity:

P&G:	2.40% vs. 1.97%
Coca Cola:	2.95% vs. 1.91%
Home Depot:	2.37% vs. 1.65%
JPM:	3.06% vs. 2.28%
Chevron:	4.01% vs. 1.92%
AT&T:	5.44% vs. 1.65%

[v] Negative-Yielding Debt by Country as of August 29, 2019 in USD trillion: Japan \$7.3T, France \$2.3T, Germany \$2.1T, Spain \$0.9T, Netherlands \$0.6T, Italy \$0.5T, Belgium \$0.4T, Switzerland \$0.3T, Austria \$0.3T, Sweden \$0.3T, USA \$0.2T