The Swiss Merchant Bank

Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News
Renewable energy has become cheaper than coal. Subsidies are, finally, no longer necessary. The majority of power growth goes into renewables. Investors in renewable energy know the precise costs for the next two decades or so whereas costs of fossil fuel or coal driven power plants are at the whims of the ups-and-downs of the commodity markets.

When equities face heavy selling pressure the price of copper consistently drops like a stone and palladium is a close second. Not last month: Copper was up 1.0%, and palladium gained 11.7%. Prices for input material for batteries and battery technology are in an upward trend due to a typical demand overhang. Thematic investing has proven its diversification benefits.

Global supply chain disruptions are already unprecedented in scale, and likely getting worse in March. This is not the time to try to be a hero, not the time to catch a falling knife.

But, it is also not the time to panic. As FDR said in 1933: "The only thing we have to fear is ... fear itself — nameless, unreasoning, unjustified terror which paralyzes needed efforts to convert retreat into advance."[i]

Politics, Economies & Monetary Policies
The media focuses on the disagreements between President Trump and the Democratic contenders. Equally interesting is on what they agree on: A protectionist, anti-China economic policy is here to stay.

The virus leads to a fall in global GDP in a moment where fragile economic growth in Europe and in the US was seeking stabilization. For China, the outbreak has paralyzed several economic sectors and tarnished the country's role as the factory of the world. China, the world's new pariah?

Equities
The yield gap between earnings yield (5.5% in the US[ii]) and the sovereign bond yield (1.2% for 10 yr US Treasuries) is way above the long-term average. Sooner or later, the yield gap is highly likely to narrow again. Valuations on dividend yielding stocks are attractive, despite adjusted outlooks on earnings.

Consider the value of dividend-paying companies. Companies with resilient cash flows help limit drawdowns during market corrections. The compounding of reinvested dividend returns adds to performance.

Our thematic approach has proven its virtue: Themes we like include Ageing Population, Cyber Security, Digitization, Automation & Robotics, Artificial Intelligence & Big Data, Water, and Biotechnology. The common denominator underpinning the investment thesis for each of these themes is a strong demand and lagging supply growth. Sectors with a wider dispersion require active managers though.

Fixed Income & Credit
A credit event is perhaps the highest yet underestimated risk. The broad market sell-off could lead to a liquidity crisis for this or that indebted company. [iii] There are serious risks of a domino effect. The credit market is vastly larger than the equity market in terms of dollar value, so the credit market is an indicator of the health of stock markets and the economy as a whole.

Sovereign bond yields underprice their inherent risks. Greece' 10 year yield has reached 1% (!) this month. What is perceived as a strong, balanced system one day could blow up the next just like Prince Rupert's Drop ("larme de verre").[iv]

Commodities
The case for gold has become stronger. The metal has no credit risk and infinite duration.

Precious Metals also remain a complementary asset class to equities. The small negative carry from holding physical gold is still better than the negative sovereign yields.

We remain bullish on Precious Metals because of an overall supply / demand imbalance. Gold has proven its place as a diversifier during the recent virus driven equity sell-off.

Alternative Funds
With rising volatility, market inefficiency rises in parallel enhancing alpha opportunities for hedge funds. However, 'alternatives' are not an asset class per se. Bottom up research, manager by manager, is the optimal process to identify the few talented long / short players in each asset class.

Asset Allocation
Diversification is key. Across asset classes use gold and, if permitted by the mandate, convex long vol strategies.

Within equities diversify between growth and value. Beware of companies with negative cash flows.

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

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

Consider adding tail hedges. Regard CHF as an asset class. Alternatively, add active strategies with uncorrelated returns and convexity. Last, and not least, cash is king as long as the current uncertainty persists.

Roland Eberhard
March 2, 2020[v]

[i] First inauguration of Franklin D. Roosevelt, Saturday, March 4, 1933

[ii] Mean earnings estimate by sell side is $162.87 on a S&P 500 Index value of 2'954.22. Quelle: Refinitiv

[iii] During the 3rd week of February the yield-to-worst of the Barclays Long US Corporate index has fallen to 3.39%, the lowest level ever. The probability of further tightening is way lower than the risk of a widening.

[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."