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The Swiss Merchant Bank

Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

The world has changed. An abnormally wide range of potential outcomes calls for reduced risk in the short-term. We suggest reinforcing diversification across various risk factors as a cushion. As we return to work the true extent of the calamity will be visible. Financial markets could react violently.[i]

Markets are in a transitory period. A new market regime will emerge at some point this year. Nobody knows how long it will last and at least the beginning will be marked by uncertainty.

Having a robust investment strategy based on a foundation of strong principles is key. Long-term, time in the market outperforms timing the market. One is better off to follow a disciplined process than reacting to swings of momentum.

Politics, Economies & Monetary Policies

China's economic recovery could well surprise on the upside with a global ripple impact.[ii] China has proven to be the most reliable manufacturing and logistics hub in the world.[iii] A lack of supply due to disrupted global supply chains could lead to sharp price increases of goods.

Health and economic matters will dominate private and public sector initiatives for years.

The pandemic has precipitated the implementation of "Modern Monetary Theory", the aggressive fiscal expansion financed by central banks. The consequences, intended and unintended as they may be, are difficult to predict. 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]

Equities

Companies that have a high chance of survival show a combination of well capitalized balance sheets, variable cost structures and recurring revenues (vs. transactional revenue).

The hit to profits and cash balances leaves corporates more indebted. Solid balance sheets will be key. Share buybacks are a thing of the past. Neither is positive for broad equity indices.

We expect dispersion to remain elevated. Such an environment favors equity long/short strategies.

Fixed Income & Credit

The U.S. oil boom died on March 6, the day Saudi Arabia and Russia ended a four-year pact that curbed output. Up to 240'000 oil related jobs will be lost this year.[v] Shale firms have accrued hefty debt during the expansion, leaving them exposed to the price crash that followed. We are still worried about a wave of defaults in the US high yield market.

Globally, loan delinquencies are most vulnerable within service sectors such as wholesale, retail, leisure, travel, etc.

Rising inflation is one of several possible scenarios, even though we believe it is too early to make predictions in either way. If (or when) bond yields rise we will witness the biggest and most brutal bond bear market in history.[vi]

Short-dated inflation-indexed bonds are a form of protection.

China trades all oil strictly only in RMB and the same goes for most other commodities. Yet, the financial world shuns RMB assets. This is likely a strategic mistake. We like RMB denominated corporate bonds of high quality issuers. The coming index inclusion of China's sovereign debt market serves as additional tailwind.

Commodities

The low oil price is likely here to stay for at least the summer period. For some commodities the cost of shipping is higher than the goods shipped which is unsustainable. We suggest rebalancing the commodity allocation.

Gold remains in an upward trend even though the strong price increase makes us less bullish than we have been for some time. The metal has no credit risk and infinite duration. The debasement of fiat currencies has further added to the attractiveness of gold.

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

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

Our coping stratagem involves a short-term risk reduction until our conviction level increases. We are actively looking to add tail hedge strategies.

We 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 overweight equities vs. bonds and we keep bonds at the lower range levels. We regard the Swiss Franc as an asset class. Commodities belong in every portfolio.

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

Roland Eberhard

May 1, 2020[vii]

[i] Scenario analysis is part of every good risk management. Consider the following: A second wave of infections is conceivable but improbable because of the measures taken. Hence, a rise of infections in any country would lead to risk assets correcting violently.

[ii] China accounted for roughly 38% of global growth before the crisis. A number of Asian countries and member states of the Belt and Road Initiative will benefit from China's growth.

[iii] Yesterday, China published their PMI data. The index of export orders fell by 28% MoM and by 32% YoY, roughly as expected. The surprise was the sharp recovery in construction, which rose by 8.3% in April. This could be the beginning of another infrastructure boom to balance the decline in exports. As the South China Morning Post reported on April 29: "While infrastructure construction plunged 19.7 per cent in the first three months of the year, recent weeks have seen a swathe of high-value projects announced by provincial governments across China, including 391 new projects worth 783.6 billion yuan (US$110.6 billion) in the southeastern province of Fujian and 2,583 new projects this year at a cost of 450 billion yuan in the landlocked easterly province of Anhui.

Beijing may hope that an infrastructure splurge will help arrest worrying reports which have placed the unofficial unemployment rate at 20 per cent. Expectations of new hiring fell across the board in the three surveys released on Thursday, with smaller, private sector manufacturers expecting a sharp drop off." (link: https://www.scmp.com/economy/china-economy/article/3082343/coronavirus-china-economy-facing-uneven-recovery-three-months)

[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."

[v] This is about a third of the onshore and offshore oilfield workforce, as estimated by the consultancy Rystad Energy.

[vi] Simplified, the pro-inflation story goes something like this: As economies start to reopen the velocity of money picks up. During the lockdowns lending was unproductive by paying for people and companies that did not produce. When velocity of money picks up from low levels commercial banks start to expand money supply. Unless central banks shrink their balance sheets by a compensating amount inflation will pick up. An estimate for the US by Macro Strategy UK is a broad money supply of USD4.4 trn, 28% higher than pre-crisis.

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