Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News: Trends for 2021
The Covid-19 crisis has caused massive dislocations. The essential question in Asset Allocation is which of these represent secular changes that cause long-term trends.

Greater fiscal spending in North America and in Europe is a certainty. With monetary and fiscal policy aligned to fight the peril of deflation it is highly likely that 2021 will be a year of strong global recovery. The enormous fiscal stimulus only strengthens the rebound.

In Europe, large part of the stimulus goes towards rebuilding the energy and transport systems. This includes extensive retrofitting of residential and commercial buildings. Should Democrats control US politics the same will be the case in the US. The shift to green energy will be as capital-intensive as post-war rebuilding.

The winners in green energy and transport will enjoy exponential growth. Most of us are under-invested in renewable energy, electric transportation and related sectors that anticipate the future. We are in the early stages of a long-term trend in ESG: Environment, Social and Governance.[i]

Politics, Economies & Monetary Policies
The broad recovery trend in the world economy will be maintained. Plus, we are getting ever closer to the introduction of effective vaccines. The new bull market in US equities is ostensibly still alive.

Central bank balance sheet expansion is still accelerating across the high-income economies, which will undercut the downside risk for stock prices. The equity market cares about expected changes in corporate earnings and interest rates. These changes may from time to time be independent of the underlying economy, if not for long.

Equities
Early this century we decided to 'front run the Chinese': We invested in everything the Chinese needed. Raw materials were a big part of it. Our travels took us to many places including Texas and Australia, even New Zealand.

Now the time has come for the opposite: We are investing in China. Investors who want a stake in China will need to own more Chinese assets. This will drive tremendous capital flows into domestic stocks and bonds.

We expect dispersion to remain high. Consequently, we focus on sub-indices. We seek alpha via active managers, particularly if they are sector specialists. Such a sector is electric transportation.

In the US, NextEra, the clean-energy utility has surpassed ExxonMobil in market capitalization. Exxon's stock was removed from the Dow Jones Industrial Average after nearly a century of membership.

A deluge of electric vehicle (EV) companies with no current income is listed in the stock markets. Investors are making big bets on revenue projections for EV companies. Companies like Nikola Corp. have benefited from the excitement. At its recent peak, Nikola's valuation surpassed $30 bln, making it worth more than Ford despite having never produced a single car and relying on GM for manufacturing and assembling its first vehicle when produced.[ii]

Fixed Income & Credit
Debt levels and yields have universally gone in opposite directions. The deep decline in bankruptcies indicates that government support measures have kept alive many unviable businesses that would have failed even in a normal year.

One big risk is that bond yields will turn positive. If we have seen the lows in inflation then correspondingly we may have also seen the highs in bond prices. Cracks appear in direct lending, which could be a precursor of things to come.[iii]

What is perceived as a strong, balanced system one day could blow up the next just like Prince Rupert's Drop ("larme de verre"). We favor equities over debt.

Commodities
The anticipated boom in EV production is set to completely upheave the landscape for raw materials used in the production of the cars. Demand is forecast to rise dramatically for all the battery commodities required.

The primary earth elements to be impacted are cobalt, copper, lithium, nickel, and manganese. EV's already account for 41% of global lithium demand. For nickel, EV market share of global demand was 3% in 2020 and is forecast to rise to 26% by 2030. For copper, EV market share of global demand was 2.4% today and is forecast to rise to 9.4% by 2030.

Asset Allocation
Early birds catch the worms: Include the CNY, Chinese bonds and domestic equities. ESG should be a part of every portfolio.

An abnormally wide range of potential outcomes calls for reinforced diversification across various risk factors. If possible, add downside protection in form of tail risk hedges.

We overweigh equities vs. bonds. We regard the Swiss Franc as an asset class. Commodities belong in every portfolio. Across asset classes use gold and, if permitted by the mandate, convex long vol strategies. Diversification is key.

Roland Eberhard
November 2, 2020[iv]

[i] The term "ESG" has established itself as the standard for sustainable investments. The three letters describe three sustainability-related areas of responsibility of companies:

1) The "E" for Environment stands e.g. for environmental pollution or hazard, greenhouse gas emissions or energy efficiency issues.

2) The "S" for Social includes aspects such as occupational health and safety, diversity or social commitment (corporate social responsibility).

3) The "G" for Governance means sustainable corporate management. These include topics such as corporate values or management and control processes (corporate governance).

Various sustainability ratings are based on the analysis of these criteria. A universal standard is not yet developed.

[ii] Nikola's shares are down 75% from their intraday high achieved shortly after its IPO in June. Other names of electric vehicle / battery companies with minimal or no revenues include in order of market cap Hyllion (HYLN.K, $2.91 bln, +89.4% YTD), QuantumScape (privately held; $3.7 bln in September 2020; listing with ticker QS in due course), Lordstown Motors Corp (RIDE.O, $2.15 bln, +31.2% YTD; stock corrected sharply after it was up 3x fold), Fisker Automotive Inc. (privately held) and Canoo (privately held with NASDAQ listing expected in due course).

[iii] Two such companies running into trouble are H2O Asset Management and RuverCap. Such cases are somehow reminiscent of the problems Baer Stearns faced in spring of 2007. See also:

https://www.reporter.am/h2o-relied-on-minor-brokerages-to-shuffle-illiquid-debt/

https://www.bloomberg.com/opinion/articles/2020-09-17/h2o-s-investors-will-rue-the-natixis-fund-s-illiquid-adventure

https://www.ft.com/content/0e21e6d0-829b-43c4-9332-92dc0115b4f1

https://www.finews.com/news/english-news/41976-ruvercap-investors-marc-clapasson-jon-turnes-criminal-investigation