

Baer Necessities

September 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

“There is no barrier for U.S. Treasury yields going below zero. Zero has no meaning, beside being a certain level.” said Alan Greenspan.ⁱ The Man in the Arena of Central Banking for longer than anyone else has hit a point: Sovereign bonds have lost their predictive power for growth and inflation. Inverted yield curves do not matter as much as they did in the past.

When capital no longer needs to earn interest for capitalism to work then there are unintended consequences. Chief among them is a wealth gap with lower and middle classes losing out. That’s the common factor between Brexit, support for European nationalists and even the Hong Kong protests. We witness a “Japanification” of the advanced economies.ⁱⁱ

Normally, global slowdowns are triggered by higher interest rates or high energy prices. Neither condition applies today.

Economies & Monetary Policies

Cheap energy nurtures economic activity.

So far, strong consumption has offset weaker manufacturing in the US. Further contraction could affect consumption and cause a recession.

The current situation for sovereigns was compared to Prince Rupert’s Dropⁱⁱⁱ (“larme de verre”), in that what is perceived as a strong, balanced system one day could blow up the next.^{iv}

Politics

Trade tensions have a debilitating effect. Still, Trump seeks re-election for which he needs a higher stock market and a growing GDP in about a year’s time.

Brexit will be center stage during September. Expect volatility.

Equities

Dividend and earnings yields compare favorably with ever lower bond yields.

With yields falling the stock market remains relatively good value despite a strong start to the year. Falling bond yields herald weak economic growth: Concentrate exposures in stocks that are not dependent on the economy for growth. This includes technology, but also sectors with stable income such as utilities, infrastructure or property trusts (REIT’s).

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.

Emerging Markets Currencies & Debt

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

Another beneficiary of the turn in monetary policy are big debtors who are dealing head-on with their debt loads. The low rates make the cost of refinancing notably lower, their relatively high-yield status more of a draw to investors, and so their heavy debt loads become more sustainable. Indeed, one underlying objective of the low-rate policy is to enable debt-stocks to be digested and grown out of. Buying long-dated bonds that have significant credit spreads of debtors typically offers good rewards in such easy-money times.

Events in Hong Kong could herald a change of paradigm but it is too early to tell.

Commodities

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.

In physical gold there is a demand overhang. This is due to higher central bank demand and lower production. Gold is the one ‘thing’ a central bank can buy that cannot be manipulated by the Americans, hence net buying by the Chinese and Russians.

Gold is the ultimate speculation since it has little industrial use and a slight negative yield. When most investment grade sovereign debt trade in negative yield gold is suddenly more attractive in relative terms.

The oil price has become a key predictor for US inflation. Fortunately, a rally in oil is a low probability due to a supply overhang especially because of the increase in US shale production.

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 anyway.

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
September 2, 2019^v

ⁱ Liz Capo McCormick, 'Greenspan Sees No Barriers to Prevent Negative Treasury Yields', Bloomberg News, August 13, 2019: Interview with Former Federal Reserve Chairman Alan Greenspan; Quote: 'He postulated that extended life expectancy and an aging population have caused people to value future consumption more than current spending. Greenspan, 93, said he views Fels's thesis as very plausible and also a reason why more debt has a yield below zero. He doesn't think it will last forever. "Why people continue to buy long-term Treasuries at such low yields may be also due to forces having altered people's time preferences," Greenspan said. "But there is hundreds of years of history showing the long-term stability in time preference, so these changes won't be forever."'

ⁱⁱ Speaking of unintended consequences: Danish Jyske Bank offers -0.5% negative rates on mortgages! It is paying people to borrow money. If you bought a house for DKK1 million and paid off your mortgage in full in 10 years, you would pay the bank back only DKK995,000. Link: <https://www.jyskebank.dk/bolig/nyheder/realcredit-med-negativ-rente>

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."

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