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Baer Necessities

February 2020

Perspectives for Strategic Asset Allocation

Observations, Markets & News

The new virus, 2019-nCov, is hard to spot and therefore hard to stop. The following thoughts estimate that the coronavirus outbreak dissipates by spring. We need to assess the development daily though. Should the virus lead to a deep, long-term economic fallout the tactical asset allocation would need to be changed quickly and drastically.

What the virus does show tragically, is the need for a balanced approach with tail hedges in a world where bonds no longer offer the desired diversification from equities.

A supply/demand imbalance drives prices more reliably than any other factor. High demand for a good with limited supply is like a force of gravity to the price in contrast to the proverbial random walk on Wall Street.

Such imbalances are found in battery technology, in bond yields, in gold and in palladium. Demographics can cause long-term imbalances.[i] We like thematic investing based on such imbalances to provide alpha while enhancing diversification.

Economies & Monetary Policies

Synchronous asset purchases in the US and in the Eurozone are positive and will last until spring for all one knows.

Among Central Banks a new theme of 'going direct' is emerging as part of the discussion of how to address an economic slowdown at current low or negative rates. Stanley Fischer, Mark Carney and Christine Lagarde have all publicly addressed the issue.[ii] Central banks are sending the clear signals that they still have arrows in the quiver.

In the European Union policy conditions have improved. The political dynamics in Brussels and Berlin have shifted in a direction more favorable to European cohesion.

Equities

For one, we are in a liquidity driven bull market. They tend to go on for longer and further than most expect. For another, the downside momentum could be sharp if sentiment changes.

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.

Interest in Biotech remains tepid despite an increasingly apparent boom in drug innovation. After strong Q4 2019 performance, the sector remains in the second quartile from the bottom of historical valuation ranges, despite low interest rates and higher valuations elsewhere.[iii] The number of companies trading below 2x cash remains high at about 177.

Fixed Income & Credit

Markets are stretched. Duration risk is high. Tight valuation limits the potential for outperformance. Bonds no longer diversify stocks with yields and spreads as low as they are.

Inflation risks look underpriced. Inflation linked bonds offer a resilience against risks of regime shifts even as such scenarios have a low probability.

High yield credit spreads narrowed to a record level at year-end but have widened this year with a positive correlation to equities.[iv] Lower rates have facilitated financing and reduced default risk. Meaningful increases in rates will result in defaults and widening of spreads of debt-laden companies.

Sovereign bond yields underprice their inherent risks. What is perceived as a strong, balanced system one day could blow up the next just like Prince Rupert's Drop ("larme de verre").[v]

Commodities

"Cash is trash.", said Ray Dalio at the WEF[vi] while Bridgewater was in the news betting on the gold price to rise by 30% with a target of $2'000/OZ.[vii]

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.[viii] 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.

Asset Allocation

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.

Keep your equities, increase precious metals, and consider adding commodities.

Roland Eberhard
February 3, 2020[ix]

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[i] Japan is a prime example: As of January Japan has 70'000 centenarians, people aged 100 years or older. There are 56.34 centenarians per 100,000 people nationwide. See also: https://www.japantimes.co.jp/news/2019/09/13/national/japan-centenarians-top-70000/#.XgePK_xOlaQ

[ii] Elga Bartsch, Jean Boivin, Stanley Fischer, Philipp Hildebrand (August 2019), *Dealing with the next downturn: From unconventional monetary policy to unprecedented policy coordination*, BlackRock Investment Institute; Available at: https://www.blackrock.com/corporate/literature/whitepaper/bii-macro-perspectives-august-2019.pdf (Accessed: Jan 29, 2020)

[iii] The Nasdaq Biotech Index is now at a Price to Sales ratio of 6.2x, and large cap biopharma (NQ US Lg Cap Pharma Index) at a P/E of 14.4x.

[iv] We use the Markit CDS North American High Yield Index as proxy and compare it to the S&P 500. Equities started selling off after the news from Wuhan on January 17 when spreads widened from less than 280 to 310 in a matter of only four days.

[v] 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."

[vi] See also: https://www.cnbc.com/2020/01/21/ray-dalio-at-davos-cash-is-trash-as-everybody-wants-in-on-the-2020-market.html

[vii] See also:

https://www.alternativesoft.com/ray-dalio-bridgewater-is-betting-on-gold-to-surge.html

Quote: "The world's largest hedge fund, Bridgewater Associates is betting on gold to surge by 30%.

The price of gold has already climbed in 2020, Ray Dalio's Bridgewater believes that gold could reach $2,000 from its current price of $1553 (rounded up).

Bridgewater have been encouraging investors to "sell the news" and put their cash into gold prior to a further surge.

Greg Jensen, Co-CIO has outlined 3 main reasons for the climb.

1) Permanent shift in Federal Reserve Policy

Jensen disagreed with unpopular opinion that the bank would normalise rates the moment the economy became stable.

Jensen believes the Fed and other central banks will hold interest rates low even if inflation begins to exceed stated targets.

He continued by warning of weakening market confidence and how it could result in equity investors taking profits, which may spiral into a "deep correction".

2) China and Iran brewing conflicts

Gold rallied in the aftermath of Soleimani's death, when investors fled from risk assets.

Geopolitical conflicts may continue to benefit gold, particularly Iran and China as Wall Street are not confident a deal will arrive.

Jensen spoke on the matter; "People should be prepared for a much wider range of potentially more volatile set of circumstances than we are mostly accustomed to."

3) US political turmoil

In November Bridgewater placed a $1.5b options bet that the stock market would plunge by March this year.

The political implications of this bet are enormous as the Democratic Primary outcome will be evident by this time, and investors may dive for haven assets like gold.

US economic growth is slowing as the largest expansion in history continues into uncharted waters.

Jensen believes the weakness of the economy could increase tensions between rich and poor people. Once again gold would become a staple."

[viii] Gold could be the harbinger of bad news in the sovereign debt markets. See comments by the Dutch Central Bank, known as De Nederlandsche Bank (DNB), which wrote on October 15, 2019 that gold would be indispensable in the event of a fiat meltdown. (!) The Central Bank wrote: "Gold is the perfect piggy bank – it's the anchor of trust for the financial system. If the system collapses, the gold stock can serve as a basis to build it up again. Gold bolsters confidence in the stability of the central bank's balance sheet and creates a sense of security."

see also:

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Baer Necessities

January 2020
Perspectives for Strategic Asset Allocation

Observations, Markets & News
The broad commodity index[i] now offers a positive roll return. US policy makers, political and monetary, are determined to cause rising inflation. If, or when, they succeed shareholders should buckle up as equity divergence will increase; one should then short USD vs. EUR since it is a lot harder to create inflation in the Eurozone. Long gold and long commodities, both traded in USD, would be winning trades, too.

If they don't succeed, expect more QE type measures, and perhaps a new US president, too. A lot is at stake.

Economies & Monetary Policies
Synchronous asset purchases in the US and in the Eurozone are positive and will last until spring for all one knows.

Politics
Political risks have abated. The trade deal could boost capital investment and trade leading to higher commodity prices.

Equities
Coordinated monetary and fiscal easing in all big economic blocs means a broad rally is sustainable. Whether the US can go on outperforming depends partly on the USD's direction.

For those questioning our positive outlook consider that the equity risk premium is currently at 6-7% (but was at -3% in 2000).[ii] Bull markets die mainly from a euphoria that is nowhere to be seen. Fiscal policy being debated everywhere has profound ramifications rendering recessions in 2020 unlikely.

Themes and sectors we like include Ageing Population, Digital or Cyber Security, Digitization, Automation & Robotics, Artificial Intelligence & Big Data, Water, and Biotechnology. Sectors with a wider dispersion require active managers though.

Fixed Income & Credit
Underweight: Markets are stretched but we have not yet arrived at the nadir in rates. Tight valuation limits the potential for outperformance. Bonds no longer diversify stocks with yields and spreads as low as they are. Duration risk is high.

We keep a positive view on the GBP following the UK election. Pound denominated corporate bonds offer upside, too.

High yield bond managers report that in several cases the market is struggling to price default probability and/or worst-case recovery potential properly.

Yields on so many sovereign bonds do not reflect their inherent risks.[iii] The current situation for sovereigns was compared to Prince Rupert's Drop[iv] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[v]

Emerging Markets: Equities, Currencies & Debt
We expect attractive returns from Emerging Market (EM) equities, performing in line with global equities. The earnings momentum has picked up and valuations of EM equities compared to global equities are reasonable. EM are anything but a homogenous bloc: Brazil and China look attractive while other LatAm markets or South Africa do not.

Local currency bonds could be alluring, particularly in Eastern Europe, Middle East and some African countries. Argentina looks enticing. The US-China trade deal will favor Asian currencies and local currency bonds.

Commodities
Relative to each other equities are expensive and commodities are cheap. The ratio of the S&P GSCI vs. the S&P 500 is now about as low as it was in 1972 (!): Commodities are over-sold and under-allocated. Commodities tend to rise in the later stages of the economic cycle. So far this has not been the case. They always swing back, often in sharp moves. Given the positive roll yield the downside risk seems limited. Commodities complement a portfolio as a hedge against rising inflation or supply interruptions due to the trade war.

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.[vi]

Asset Allocation
Humans tend to extrapolate recent events, and as investors we tend to overstay our welcome. If we just look back, we can't see what's coming. Just as 2019 turned out a whole lot different than 2018 so will 2020. This year will provide opportunities and risks divergent and new.

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 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. Alternatively, add active strategies with uncorrelated returns and convexity.

Keep your equities, increase precious metals, and consider adding commodities during Q1 2020. Happy New Year!

Roland Eberhard
January 2, 2020[vii]

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[i] S&P Goldman Sachs Commodity Index (S&P GSCI)
The forward curve of Brent and WTI is in backwardation due to supply cuts. Crude production growth has weakened and prices will need to go higher for it to revive. Given OPEC's ongoing cuts, strength for Brent is likely to remain.
Incredible anecdote: In the first week of December, for the first time ever, the market cap of Apple surpassed that of the entire S&P 500 Energy Index, which includes America's 28 largest energy firms such as Exxon Mobil and Chevron. Interestingly, both Apple and the S&P 500 Energy Index (i.e., the combined 28 companies) generated roughly $58 billion in cash flows (after operating costs) over the last 12 months, which is a 4.8% free cash flow yield. By this comparison, the similar valuations make sense.
While we do believe that renewable energy, electric vehicles and synthetic plastics will curtail conventional energy demand growth in the coming decades, eventually leading to a prolonged decline, it is unlikely that oil and gas are anywhere close to disappearing. For the contrarian investor, we think it is perhaps a signal to consider a moderate investment in an economically vital sector.
(Source: Morgan Stanley and proprietary research)

[ii] All forecasts will be wrong to some degree by definition. Still, projections by The Capital Spectator tend to be roughly correct, which are as follows for 2020: 6.2% US Stocks; 7.2% Non-US DM Stocks; 8.3% EM Stocks; see also https://seekingalpha.com/article/4310422-risk-premia-forecasts-major-asset-classes-3-december-2019
or http://www.capitalspectator.com/

[iii] Bloomberg published a thought-provoking article on November 13, 2019 (Brandon Kochkodin, Bloomberg, 'LTCM Co-Founder Finds Infinite Value in Bonds on Negative Rates'). Quote: "Perhaps more realistically, consider Austria's 100-year bond, one of the closest approximations to a modern-day sovereign perpetual bond out there.

The same bond-pricing calculator produces a price of 173 euros when you use its current yield of 0.95% as the discount rate, an indication the market expects interest rates to average about 1% over the remaining 98 or so years of the bond's life.

But assume the discount rate falls to -0.5% and then stays there, then the bond's expected price shoots past 400 euros."

[iv] Equinox Partners

[v] 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.

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Baer Necessities

December 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

Markets are stretched but we have not yet arrived at the nadir in rates. The zenith of equity markets will likely be reached when the discount rate rises. Equity markets still offer an attractive earnings yield compared to low interest rates.

Sell in May and go away? – A possible motto for 2020 since the current QE by the Fed runs out in April and the Democratic contender will be known only in about May or late spring.

A weak US dollar and strong Emerging Markets (EM) remain a high likelihood as detailed last month. The Fed aggressively expanding the supply of US dollars is bearish for dollars.

Economies & Monetary Policies

Markets are caught in a balancing act between strong consumption and weak manufacturing.[i] Growth in global industrial production should turn up over the coming months as a result of further central bank easing. Although the recovery is expected to be shallow, it will add to the service sector's resilience to prolong the economic cycle.

Politics

We know for certain to face a drawn-out primary season in the battle for the Democratic candidate. Super Tuesday[ii] is March 3 but the decisive date is more likely April 28[iii] even though the last primary election is as late as June 16.[iv] Should Elizabeth Warren win the Democratic nomination then her policies will be seen as equity- and dollar-negative. To be clear though: The odds remain wide open.

Japanification remains the main risk in Europe. Correcting property values are part of such a scenario. This month marks the 30th anniversary of the top of the Nikkei 225[v]: The market has since corrected by -40.2%. Put differently, equities would have to rise 67.2% to reach the all-time high again.

Let's hope for an end to the intra-Asian trade war between Japan and South Korea as the regional supply chain is being interrupted.

Equities

We remain positive on equities with a preference for US stocks, as we have been since January.

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

Note though: Sectors with wider dispersion require active managers.

Fixed Income & Credit

Global government bonds are expensive. Yields on so many sovereign bonds do not reflect the inherent risks.[vi] The current situation for sovereigns was compared to Prince Rupert's Drop[vii] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[viii]

Global investment grade (IG) bonds are also expensive. For instance, more than 40% of the EUR corporate IG universe delivers negative yields.[ix] For US IG spreads remain supported by "the search for yield" at least until supply pressure returns.

Remain underweight credit and expect a rising default rate at some point, 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. Active strategies should outperform passive ETF's.

Commodities

Precious Metals 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 as we have been since January because of an overall supply/demand imbalance. Gold could be the harbinger of bad news in the sovereign debt markets. See comments by the Dutch central bank below.[x]

Political progress on trade and a recovery in manufacturing are expected to be positive for cyclical commodities. We have no strong view on oil, natural gas or European power.

Asset Allocation

When markets are at record highs and geopolitical uncertainty is increasing one becomes more conservative by buying higher quality assets. With yields at rock bottom equities with steady earnings and high free cash flows become attractive. The yield of future dividends provides a floor to the downside.

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.

Consider adding tail hedges provided the mandate permits it. Alternatively, add active strategies with uncorrelated returns and convexity.

Hold Precious Metals.

Roland Eberhard

December 2, 2019[xi]

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[i] The US saw 3Q19 GDP revised up by 20bp to 2.1% last week, with the bulk of that coming from slightly better consumption, a somewhat smaller drag from investment, and a more positive contribution from inventories. October durable goods report was strong; better shipments will support 4Q business investment in GDP tracking, and better orders indicate some momentum on a forward-looking basis.

[ii] Super Tuesday (March 3): Alabama, Arkansas, California, Colorado, Massachusetts, Minnesota, North Carolina, Oklahoma, Tennessee, Texas, Utah, Vermont and Virginia primaries

[iii] April 28: Connecticut, Delaware, Maryland, Pennsylvania and Rhode Island primaries

[iv] June 2: Montana, New Jersey, New Mexico and South Dakota primaries

June 7: Puerto Rico Democratic primary

June 16: Washington, D.C., Democratic primary

[v] The average hit its all-time high on 29 December 1989, during the peak of the Japanese asset price bubble, when it reached an intra-day high of 38,957.44, before closing at 38,915.87, having grown sixfold during the decade. (Source: Wikipedia)

[vi] Bloomberg published a thought-provoking article on November 13, 2019 (Brandon Kochkodin, Bloomberg, 'LTCM Co-Founder Finds Infinite Value in Bonds on Negative Rates'). Quote: "Perhaps more realistically, consider Austria's 100-year bond, one of the closest approximations to a modern-day sovereign perpetual bond out there.

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[ix] Source: Factset, Bloomberg, Credit Suisse
Last data point: 29.11.2019

[x] The Dutch Central Bank, known as De Nederlandsche Bank (DNB), wrote on October 15, 2019 that gold would be indispensable in the event of a fiat meltdown. The Central Bank writes: "Gold is the perfect piggy bank – it's the anchor of trust for the financial system. If the system collapses, the gold stock can serve as a basis to build it up again. Gold bolsters confidence in the stability of the central bank's balance sheet and creates a sense of security."

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Baer Necessities

November 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News
Are a weak US dollar and strong Emerging Markets (EM) the trends of 2020? - The likelihood for a weaker US dollar has increased due to:

1) the Fed's mini-QE of USD60bn per month;
2) US rate cuts are more likely than other central banks;
3) no-deal Brexit risk has receded, supporting GBP and EUR;
4) likely trade deal with China;
5) rising odds that Elizabeth Warren will win the Democratic nomination, and her policies are dollar-negative

Meanwhile, EM benefit from fiscal, regulatory and monetary stimulus. A weak US dollar is usually good news for EM. The new Chinese stimulus is positive for EM, not only in Asia. Market friendly changes are underway in several countries. These include fiscal reforms (Brazil, India), structural regulatory changes (Brazil, India, Indonesia), or interest rate cuts (India, Indonesia, Russia and others to follow).

Economies & Monetary Policies
Ongoing strength in consumer spending in the USA has so far helped to offset weakness in manufacturing.

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

Politics
A trade deal between the US and China is likely signed in November. Trump needs a quick deal. There is mounting evidence of the impact the trade war has had on US manufacturing, agricultural incomes and business confidence. Additional tariffs could severely damage re-election chances.

Trump's impulsive actions and amateur deal making are devoid of plan, process and historical knowledge. His erratic behavior is a permanent tail risk to financial markets.

Equities
We remain positive on equities with a preference for US stocks, as we have been since January. Q3 earnings season has overall been above expectations with positive forecasts.

Many 10yr government bond yields have fallen to less than 1%, and this means the stock market remains relatively good value. Falling bond yields obviously herald weak economic growth. Concentrate long exposures in stocks that are not dependent on economic growth. But trees do not grow to the sky. Let us keep this in mind.

Themes and sectors we like include Ageing Population, Digital or Cyber Security, Digitization, Automation & Robotics, Artificial Intelligence & Big Data, Water, and Biotechnology. Note though, sectors with wider dispersion require active managers.

Fixed Income & Credit
Yields on so many sovereign bonds do not reflect the inherent risks. Remain underweight credit and expect a rising default rate, particularly among high yielding debt.

The world has gone bananas: Greek debt offers negative yield. Investors pay for the right to own Greek debt.[iii] Greece is rated B by Fitch and by S & P, has a debt-to-GDP ratio of 182%, a youth unemployment of 40%, and its nominal GDP has shrunk by 23% in the past decade. Greece has defaulted eight times and has been in default for 90 of the past 200 years.

Emerging Markets Currencies & Debt
Differentiation among EM is key in all asset classes. Favor countries that are pursuing integrationist policies. Active strategies should outperform passive ETF's.

Hong Kong has fallen into recession, hit by more than five months of anti-government protests that show no signs of relenting. - A bail-out is unlikely, which could mean a permanent change for Hong Kong's status.

Commodities
Precious Metals 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 as we have been since January because of an overall supply/demand imbalance. Gold could be the harbinger of bad news in the sovereign debt markets. See comments by the Dutch central bank below.[iv]

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
November 1, 2019[v]

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[i] Equinox Partners

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[iii] see also: 'Even Greece Is Getting Paid to Borrow Money in Debt Markets', Michael Hunter, Bloomberg, October 9, 2019; https://www.bloomberg.com/news/articles/2019-10-09/greece-draws-negative-yield-for-first-time-in-3-month-bill-sale

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Baer Necessities

October 2019

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

October 1, 2019[vi]

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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

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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 Drop[iii] ("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]

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The Swiss Merchant Bank

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[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/realkredit-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.

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Baer Necessities

August 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

Financial markets decoupled from the real world by appreciating strongly in the context of a continued economic deceleration. Either the global economy will rebound as priced in or we experience a major price correction at some point. Markets will converge at some moment. But when and how?

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.

One such strategy is merger arbitrage where M&A deal activity remains elevated due to high corporate cash holdings and cheap financing. Fixed income and vol arb profit from benign volatility levels in bond markets and asymmetry of returns.

A macro trade example would be to short Hong Kong property or the Hang Seng Index. Property has become too expensive for the young, they face a weakening Chinese economy and the Hong Kong $ peg leads to adjustments via asset prices.[i]

Economies & Monetary Policies

The global growth outlook is uncertain and weak. Globally, low interest rates are a symptom of deep structural issues with accommodative monetary policy being a necessary condition for sustaining the upturn. The Fed is being expected to keep rates low until the election, which is still 15 months away.

Once the markets perceive central banks as being done with easing the QE trade will unwind. A clear sign is that corporate bond spreads have widened despite sovereign bond yields dropping.

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

Brexit: A no-deal withdrawal on October 31 promoted by the newly appointed Prime Minister Johnson could see GBP/USD fall below the historic low reached in 1985. Under this scenario we would expect a rate cut by the Bank of England to ease financial conditions amidst the inevitable slowdown.

The White House treats tariffs and sanctions as key policy tools. At least, the US President seeks re-election for which he needs a higher stock market and a growing GDP.

Equities

US equity indices have reached new all-time highs. The MSCI World is not much below the high reached in January 2018. The S&P 500 surpassed 3000 for the first time ever. Asian shares ended the month at roughly 6-week lows on trade worries. Bulls would point out that the S&P 500 forward P/E ratio is only slightly above the average of the 1990's.[iv]

As software applications proliferate, the complexity of collecting and organizing enterprise data has only increased. This is a sub-sector in tech with strong growth potential.

Fixed Income & Credit

Among Western sovereigns only the US returns a positive yield for the entire curve. The entire Swiss yield curve is negative, the only country in the world with such a distinction. For German debt, all but the 30-year are negative.

Another way to look at the entire universe of negative yielding debt is by maturity. 18 countries have a 1-year debt trading at yields below zero.

USD bulls vs. bears: The positive interest rate differential between the USD and the other currencies pushes the USD higher, or at least prevents it from falling.

Emerging Markets Currencies & Debt

Big beneficiaries of the monetary-policy turn are the more fragile EM economies. The rate differential between DM and EM point to potentially sustained capital flows into EM 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.

Commodities

Gold trades at a 6-year high. The gold/silver ratio is at a 25-year high. US led trade wars create uncertainty, a positive for gold, but weighs on silver.[v] Supply of physical gold is tight, leading to a gap risk of higher prices. We remain bullish gold.

Asset Allocation

In conclusion, we are a lot less optimistic but not bearish.

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.

Roland Eberhard

August 1, 2019[vi]

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The Swiss Merchant Bank

[i] The trade war has real consequences. Take this news story dated July 3, 2019 from Reuters: "Several technology companies, including HP Inc HPQ.N, Dell Technologies DELL.N and Microsoft Corp MSFT.O, are planning to shift substantial production capacity out of China, Nikkei reported on Wednesday, citing sources.

HP and Dell are planning to reallocate up to 30% of their notebook production out of China, Nikkei said.

Microsoft, Google, Amazon.com Inc AMZN.O, Sony Corp 6758.T and Nintendo Co Ltd 7974.T are also looking at moving some of their game console and smart speaker manufacturing out of the country, Nikkei added."

[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.

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[iv] The S&P 500 P/E Ratio Forward Estimate is about 17.9 now vs. 15.4 then. The actual P/E is 20.73 as of yesterday's close.

[v] Roughly, industrial use for silver is 60% of annual demand while industrial use for gold is 10% of annual demand.

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Baer Necessities

July 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

Facebook unveiled a consortium to create an open-source digital currency called Libra, set to bring payments to WhatsApp and Messenger in 2020. This would allow consumers to send money around the world easily and for free.

This does not yet matter for Asset Allocation but it may soon: The FT reported that Facebook "hopes Libra will become a global digital reserve system." The digitization of the financial system is the defining paradigm of the coming decade.

Markets display characteristics of a late-cycle: Growth is slowing, liquidity is tight, and volatility is elevated. Earnings growth declines but low nominal and real rates can support P/E multiples.

Economies & Monetary Policies

Although the US has now broken the previous record (set in 1991 to 2000) by entering its 11th year without a recession, other countries have avoided recessions for far longer. Australia is now in its 28th year without one, while Britain had no recessions for 17 years from 1992 to 2008—and both these economies should be quite recession-prone due to their dependence on speculative property sectors.[i] Reversion to the mean is not a reliable reason to see an end to this economic expansion particularly if the Fed eases in July.

The total amount of negative-yielding debt crossed the $13 trillion mark. Circa 40% of global bonds are now yielding less than 1%.[ii] Negative sovereign bond yields have reached 30Y in Switzerland and 15Y in Germany and the Netherlands. Outside the Eurozone negative yields are up to 10Y in Japan, Denmark, Finland and Sweden.

This is the environment in which the Fed is lowering rates. A rising inflation rate has become a more likely scenario.

Long Swiss Franc? - Consider that the CHF has historically been the best performing currency during a Fed easing cycle and one of the top three performers during a US recession.[iii]

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

Politics

President Trump appears frequently as erratic. Decisions are made hastily. This poses risks investors cannot specifically prepare for. At least, the US President seeks re-election for which he needs a higher stock market and a growing GDP in about 15 months' time.

Equities

Counting down a Fed rate cut means the market is hanging on by a (thin) thread.

Healthcare is a super trend with structural changes in the Western world. In the US, spending has risen from below 10% to 12% and is set to head upward to 17%.[vi] Biotech is where science merges with IT leading to radical innovation.

The introduction of 5G as the latest iteration of cellular technology is already creating winners and losers, an optimal environment for technology sector specialists.

Fixed Income & Credit

Outstanding junk bonds have reached $1.23 trillion, more than double the level a decade ago.[vii]

US credit spreads widened to 132 bps Investment Grade[viii] and to 464 bps High Yield[ix]. Corporate debt levels remain at all-time highs, especially if one excludes the 8-10 largest cash rich tech companies. The situation in the US oil & gas sector could lead to bankruptcies and distressed opportunities already this year.

A slowdown in the US could hit direct lending hard. Bond yields in EUR and CHF foster business but present an unattractive risk/reward.

Emerging Markets Currencies & Debt

Bond prices reflect inflationary expectations and the likely responses from central banks. In EM, strong economic growth invariably means higher inflation in some countries.

The MSCI China A shares inclusion is a structural change that naturally attracts foreign money. Despite the run-up this year the sentiment for Chinese equities is bullish.[x]

Commodities

Further incidents of the tension between the US and Iran could compel both sides to a spiral of escalation that could see crude shipments interrupted and pushing oil prices sharply higher.

Our bullish stance on gold since the beginning of the year has come true. Supply of physical gold is tight, leading to a gap risk of higher prices. For now, the trend is your friend.

Asset Allocation

In conclusion, we are a lot less bullish but not bearish.

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.

Roland Eberhard

July 1, 2019[xi]

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[i] Anatole Kaletsky, Gavekal Research, June 10, 2019: "Not Such A Dystopian Market"

[ii] https://www.marketwatch.com/story/value-of-debt-with-negative-yields-nears-12-trillion-2019-06-18 & https://www.bloomberg.com/news/articles/2019-06-21/the-world-now-has-13-trillion-of-debt-with-below-zero-yields

[iii] JP Morgan, Paul Meggyesi, June 10, 2019: https://www.bloomberg.com/news/articles/2019-06-10/fed-easing-history-shows-swiss-franc-as-best-bet-jpmorgan-says

[iv] Equinox Partners

[v] 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.

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[vi] Gavekal Research: "And as America ages, mandatory spending on social security, Medicare and Medicaid will rocket higher. For years, that spending remained below 10% of GDP. Today, it stands at 12%, and in the coming decade, as the chart below shows, it is set to head relentlessly upward to 17%." - The Case Of The Missing Inflation: US Fiscal Policy; Louis Gave; April 29, 2019

[vii] https://www.bloomberg.com/news/articles/2019-06-21/the-world-now-has-13-trillion-of-debt-with-below-zero-yields

[viii] JPM Investment Grade Index

[ix] JPM High Yield Index

[x] MSCI announced the decision on Feb 28, 2019: China is increased from 5% to 20% in three steps in May, August and November 2019. "On completion of this three-step implementation, there will be 253 Large and 168 Mid Cap China A shares, including 27 ChiNext shares, on a pro forma basis in the MSCI Emerging Markets Index, representing a weight of 3.3% in the pro forma index." see: https://www.msci.com/documents/10199/43f3ee8b-5182-68d4-a758-2968b4206e54

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Baer Necessities

June 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News
In God we trust, but everyone else please bring data: A clear trend is towards digitization. To keep an edge one has to use algos to support what remains a discretionary investment process. In turn, this has a key implication because the observer effect[i] tends to kick in. As more market participants apply a somewhat systematic approach the market itself adapts. These are factors to keep in mind.

Economies & Monetary Policies
Economic growth is real but softening. Investors are more concerned about growth than about inflation. The US treasury yield curve inverted as one of the most reliable warnings of looming recession with 3mth bills at 2.3% and 10yrs at 2.1%. Minor disappointments in activity and inflation could be sufficient for preventive rate cuts.

In Europe with rates in negative territory the central banking era is ending, replaced by politics.

In Turkey Erdogan's policies have ramifications for European growth. In Germany, the slowdown in GDP growth can be explained by Turkey and by Brexit. Neither of these two factors is likely to get better anytime soon.

Still, 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
Biggest political risk is the US tariff policy. No country is immune from a capricious US foreign policy.

Modeling trade tariffs is in fact complex. How a nation's currency adjusts to new tariffs, how corporate profit margins shrink and how consumers react is difficult to predict. This unpredictability causes market jitters. Take rare earth metal exports as an example: Once Apple announces the product launches for November 2019 China has a mighty power over Apple and their input costs into 2020. How can a shareholder model that?

Equities
The US equity market is volatile and fully-priced. Looking at dividend yields, European equities are attractive.

Healthcare is a super trend with structural changes in the Western world. In the US, spending has risen from below 10% to 12% and is set to head upward to 17%.[iv]

We remain bullish biotech where infotech is merging with medical science leading to drastic changes. Price/sales ratios remain close to historic lows. M&A is picking up, too.

The introduction of 5G as the latest iteration of cellular technology is already creating winners and losers, an optimal environment for technology sector specialists.

Fixed Income & Credit
US credit spreads blew out to 144 bps Investment Grade and to 467 bps High Yield. Corporate debt levels remain at all-time highs, especially if one excludes the 8-10 largest cash rich tech companies. The situation in the US oil & gas sector could lead to bankruptcies and distressed opportunities already this year.

A slowdown in the US could hit direct lending hard.

Bond yields in EUR and CHF foster business but present an unattractive risk/reward to investors.

Emerging Markets Currencies & Debt
Bond prices reflect inflationary expectations and the likely responses from central banks. In EM, strong economic growth invariably means higher inflation in some countries.

The MSCI China A shares inclusion is a structural change that naturally attracts foreign money. Despite the run-up this year the sentiment for Chinese equities is bullish.[v]

Commodities
Many oil & gas producers are not in good shape. Despite production growth of about 16% in oil alone this year[vi] it is economically not viable. Economically, price should equal marginal cost. But that's not the case now.

The roll yield of the S&P GSCI index has turned positive, meaning there is positive carry in holding the GSCI basket (energy, agriculture, livestock and metals). This could mark a floor in the index level as it is likely to attract buyers

Asset Allocation
In conclusion, we are a lot less bullish but not bearish. Positives remain a slush of liquidity and a US President who seeks re-election for which he needs a higher stock market and a growing GDP in about 15 months' time. But risks are rising.

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.

Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

Roland Eberhard
June 3, 2019[vii]

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[i] Also referred to as the Heisenberg uncertainty principle where the mere observation of a phenomenon inevitably changes that phenomenon. Put differently, the instrument that measures something influences the thing it measures.

[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.

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[vi] https://oilprice.com/Energy/Crude-Oil/US-Shale-Oil-Production-Set-To-Grow-16-This-Year.html

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Baer Necessities

May 2019
Perspectives for Strategic Asset Allocation

Observations, Markets & News
The Fed's indication to keep rates on hold well into 2020 is clearly bullish for economies and markets. Data releases in April have confirmed a rebound in economic activity. Global equities rose with US stocks closing at or near record highs.

Two major risks are rising inflation and politics as discussed below. The return of inflation could be more of a risk than presently discounted. But, low inflation along with strong global economic activity means that we remain in a bull market.

The cyclical upswing should lead to rising asset values of equities but also of some commodities. The trend will continue until growth disappoints or inflation rises.

Economies & Monetary Policies
The pressures usually leading to recessions are still absent: Solid private savings, no visible over-investments in any particular sector, and sound bank balance sheets lead us to expect more years of growth. This is even true for Europe where final domestic demand is around trend of 1.5% with a supportive monetary policy, declining fiscal headwinds with politics shifting to fiscal expansion, and recapitalized bank balance sheets.

There are no signs of rising inflation but two major factors to watch are wage inflation and rising oil prices.

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

Politics
Biggest political risk is the US tariff policy that could lead to actual trade wars. The risks seem a bit lower than they used to because Trump looks to be already in pre-2020 election mode when he is going to need a strong economy and stock market.

Equities
The US equity market is volatile and fully-priced. In comparison, we favor European equities. European volatility is unusually cheap, both absolutely and relatively. Euro Stoxx 50 one-month implied vol hit a record low last week. Looking at dividend yields, European equities are also cheap compared to US stocks.

Healthcare is a super trend with structural changes in the Western world. In the US, spending has risen from below 10% to 12% and is set to head upward to 17%.[iii]

We remain bullish biotech where infotech is merging with medical science leading to drastic changes. Price/sales ratios remain close to historic lows. M&A is picking up, too.

The introduction of 5G as the latest iteration of cellular technology is already creating winners and losers, an optimal environment for technology sector specialists investing long and short.

Fixed Income & Credit
Low yields reflect low inflation expectations. Better economic data could lift bond yields but limited due to presumed monetary policy responses. Corporate debt levels remain at all-time highs (especially if you exclude the 8-10 largest cash rich tech companies).

Bond yields in EUR and CHF foster business but present an unattractive risk/reward to investors.

Emerging Markets Currencies & Debt
Bond prices reflect inflationary expectations and the likely responses from central banks. In EM, strong economic growth invariably means higher inflation in some countries.

The MSCI China A shares inclusion is a structural change that naturally attracts foreign money. Despite the run-up this year the sentiment for Chinese equities is bullish.[iv]

Commodities
Commodity traders report tight markets. There remains upside risk in oil prices.

Spot prices for oil have risen sharply this year. Oil markets surged after the announcement that the US will eliminate waivers for nations importing crude oil from Iran. While forward curves trend lower a further rise would lead to inflationary pressures. Oil importing countries such as India and Indonesia have seen their equity markets correct for precisely this reason.

Asset Allocation
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.

Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

Roland Eberhard
May 1, 2019[v]

[i] Equinox Partners

[ii] 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.

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[iii] Gavekal Research: "And as America ages, mandatory spending on social security, Medicare and Medicaid will rocket higher. For years, that spending remained below 10% of GDP. Today, it stands at 12%, and in the coming decade, as the chart below shows, it is set to head relentlessly upward to 17%." - The Case Of The Missing Inflation: US Fiscal Policy; Louis Gave; April 29, 2019

[iv] MSCI announced the decision on Feb 28, 2019: China is increased from 5% to 20% in three steps in May, August and November 2019. "On completion of this three-step implementation, there will be 253 Large and 168 Mid Cap China A shares, including 27 ChiNext shares, on a pro forma basis in the MSCI Emerging Markets Index, representing a weight of 3.3% in the pro forma index." see: https://www.msci.com/documents/10199/43f3ee8b-5182-68d4-a758-2968b4206e54

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Baer Necessities

April 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

What a start to the year: Global stocks up 11% (best since 2010), the S&P500 up 13% (best since 2009), China's CSI 300 up 29% (best since 2014)![i]

Fundamentals have clearly turned weaker. Equities rallied because of a change of monetary policies and fiscal stimulus. Financial markets have become riskier in that less liquidity drives prices, historically a precursor to large market declines.[ii]

Economies & Monetary Policies

Generally speaking, global data continued to deteriorate, but at a decelerating rate. The big question is the magnitude of the economic slowdown that the US will face and the impacts of this on the rest of the world and risk assets in general.

Several reserve banks have made subtle but important changes to their commentary which is bullish and highlights that the path to more normal rates of interest will not be easy or soon. Are central banks at the end of their wisdom?

The risk reward for bears is now strongly in their favor. In the past eight years or so we have seen a bull market based on stimulus from central banks and economic growth. Macro data has now turned, and central banks have realized that tightening via either higher rates or balance sheet reduction is not an option.

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

Politics

In Europe expect a fiscal policy in the form of stimulus programs, tax cuts or subsidies as gifts for voters. In France, Emmanuel Macron faces the yellow vests. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending.

Equities

As passive money and computer driven trading strategies are becoming a bigger proportion of market trading volumes, we expect the frequency of sharp momentum reversals to grow. Yet, it does provide buying and selling opportunities for fundamental investors.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating. M&A is likely to pick up, too.

The entire Japanese market appears undervalued. The end of the financial year could see a re-rating starting in April with the psychological boost of the start of 'Reiwa', the new imperial period.

Fixed Income & Credit

Rates volatility should continue to fall creating a positive environment for high yielding bond positions.

Being long US Treasuries seems an attractive risk / reward as long as the Fed's tightening is on hold. In fact, leading indicators like housing and autos predict a further weakening of the US economy in which case rates could actually drop, a scenario neither expected or priced in.

Corporate debt levels are at all-time highs (especially if you exclude the largest cash rich tech companies). Expect default rates to rise as we move forward in time towards the heavy maturity wall in 2020-2021.

Emerging Markets Currencies & Debt

The macroeconomic backdrop for emerging markets (EM) remains healthy. Valuations are attractive, and currencies are undervalued.

Broadly speaking, EM sovereign credit remains in a sweet spot offering good valuations and carry.

As always, there are outliers with political risk such as Brazil. Argentina is an asymmetric opportunity into this year's election. Turkey created a liquidity squeeze in the offshore lira market to curtail currency shorting with potentially devastating effects. Specifically, it will deter international investors who will be asked to refinance some $177 billion of foreign currency debt coming due over the next year.

Commodities

US shale oil production has been hugely positive for US economic growth with the added benefit of lowering the cost of energy. But the end of the cycle is nearing. Share price performance of shale companies is beginning to lag traditional oil drillers.

Gold should do well with a possible demand overhang. Metals are in a prolonged supply deficit.

Asset Allocation

Overweight liquid asset classes to stay flexible and nimble.

Central Bank policy broadly speaking is positive for long-term assets including equities and bonds. But, it is hard to get excited about bonds at current yields, so we favor equities, both in the US and abroad. Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

We are amidst a megatrend of technological disruption. As the world goes digital overweight the disrupters.

Underweight financials: Credit growth is tepid and Asset Liability Management at low or negative rates is a headwind for profitability.

Shorter-term, equity vol is likely to subside while macro vol (rates and FX) increases. This should be positive for Relative Value strategies.

Consider spending money on insurance to protect against binary events that could cause sharp falls in asset prices.

Roland Eberhard

April 1, 2019[v]

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[i] The longest bull market in US history celebrated its 10th anniversary on March 9, 2019. Since the S&P 500 bottomed out at 676.53 on March 9, 2009 it has more than quadrupled.

[ii] On the S&P 500 futures contract, order book size and trade size relative to market cap have come down by more than 70% in the last two years.

[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.

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Baer Necessities

March 2019

Perspectives for Strategic Asset Allocation

Observations, Markets & News

Even with central banks on pause, the widespread economic slowdown in the developed world is likely to continue.

Market direction in Q1 2019 has so far been the opposite of Q4 2018. As passive money and computer driven trading strategies are becoming a bigger proportion of market trading volumes, the frequency of sharp momentum reversals will grow.

Key markets to monitor are the US dollar, the 10-year US treasury yield, US corporate spreads, and the price of oil. It is the interactions of these prices that decide the majority of other prices in the world's economic and financial system.

Consider spending money on insurance: Brexit and US tariffs are binary events that could cause sharp falls in asset prices.

Economies & Monetary Policies

Global inflation remains subdued. Authorities will be ever more prone to use monetary and fiscal tools to dampen volatility. Elevated debt levels make corporations and households increasingly sensitive to changes in interest rates and thus it is not a surprise that credit creation has stalled. Credit growth is now roughly 0% across the developed world.

US economic growth slowed moderately in Q4 2018 to an annualized GDP growth of 2.6%. Existing home sales fell 1.2% in January to a 3-year low. Jobless claims are rising to now 225'000.

Economic slowdown across the developed world outside the US likely represents a bullish scenario for the USD. Historically, easing financial conditions in the developed world relative to the US have corresponded with weakening FX rates vs. the USD.

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

Politics

A notable shift from monetary policy to fiscal is under way in North America and in Europe. If a 'no deal' Brexit scenario is avoided the UK economy will assuredly get a boost.

In Europe expect a fiscal policy in the form of stimulus programs, tax cuts or subsidies as gifts for the voters. In France, austerity is dead as Emmanuel Macron faces the yellow vests. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending.

Equities

For US equities we expect lower returns with wider dispersions and higher volatility. Technology, while still an incredible powerful agent of change, faces more valuation and regulatory headwinds than in the past. Cloud companies seem to grow strong independent of economic cycles.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating. M&A is likely to pick up, too.

The entire Japanese market appears undervalued. The end of the financial year could see a re-rating starting in April. Japan remains the only country in the world still continuing with a policy of qualitative and quantitative easing. The yield on the 10-year JGB remains around 0%. In other words, the equity risk premium is now about 8-9%, making Japan one of the most undervalued markets.

Fixed Income

Recent economic deterioration will be sufficient to ensure that G4 central banks will be on hold in 2019, with a higher risk of easing than tightening. The implication of this view is that rates volatility should continue to fall creating a positive environment for high yielding bond positions.

Being long US Treasuries seems an attractive risk / reward as long as the Fed's tightening is on hold. In fact, leading indicators like housing and autos predict a further weakening of the US economy in which case rates could actually drop, a scenario neither expected or priced in.

Emerging Markets Currencies & Debt

The macroeconomic backdrop for emerging markets (EM) remains healthy. Valuations are attractive, and currencies are undervalued. After a strong start to 2019 EM assets are likely to continue recovering.

Broadly speaking, EM sovereign credit remains in a sweet spot offering good valuations and carry.

As always, there are outliers with political risk such as Brazil. Argentina is an asymmetric opportunity into this year's election.

Commodities

Oil looks also to be in an upward trending market. OPEC's firm language reiterated its commitment to production cuts.

Gold should do well with a possible demand overhang.

Palladium hit a record high. Metals are in a prolonged supply deficit. In metals mining capital expenditure fell to $38bn in 2018 from a peak of $77bn in 2012. This has led to shrinking stockpiles for copper, zinc and nickel.

Asset Allocation

Overweight liquid asset classes to stay flexible and nimble.

Overweight equities since corporate bonds are unattractive in their risk / return and other asset classes are lagging. Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

Shorter-term, equity vol is likely to subside while macro vol (rates and FX) increases. This should be positive for Relative Value strategies.

Roland Eberhard

March 1, 2019[iii]

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[i] Equinox Partners

[ii] 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.

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INPUT FOR STRATEGIC ASSET ALLOCATION

FEBRUARY 2019

PERSPECTIVES (3-6 MONTHS)

Observations, Markets & News

Conviction levels are low. Traders run small amounts of risk and focus on the short-term. This is not the market to have long-term views. The longer the uncertainty about global economic growth persists, the sooner the often-voiced weakness of the economy becomes a self-fulfilling prophecy. In about one to two months, we will have clarity on Brexit and the US-China Trade War[i]. Now that the Fed's Quantitative Tightening is on hold this could be positive for risk assets.

Key markets to monitor are the US dollar, the 10-year US treasury yield, US corporate spreads, and the price of oil. It is the interactions of these prices that decide the majority of other prices in the world's economic and financial system.

Consider spending money on insurance: Brexit and US tariffs[ii] are binary events that could cause sharp falls in asset prices. Eventually, this bubble has to delever but this time credit is not only on banks' balance sheets but also in high yield markets.

Economies & Monetary Policies

Now that the Fed pauses monetary policy is favorable for the risk / return equation. Still, we remain overall in an environment of tightening liquidity conditions amidst higher real rates.

We do not expect the ECB to be as quick as the Fed to switch policy stance if the euro region's slowdown worsens.[iii] Despite a recession in Italy and a significant loss of economic momentum in Germany, the ECB isn't showing much urgency to reverse course on a stimulus-withdrawal path that was originally supposed to include an interest-rate increase.

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

Politics

A notable shift from monetary policy to fiscal is under way in North America and in Europe. A selfish disregard for the future has attracted the ire of voters and demonstrators, a trend that is likely to continue in this year's elections.

In France, austerity is dead in that the Government will not risk further discontent. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending. This is the path Europe is on.

Equities

For US equities we expect lower returns with wider dispersions and higher volatility. Technology, while still an incredible powerful agent of change, faces more valuation and regulatory headwinds than in the past. Cloud companies seem to grow strong independent of economic cycles.

As of now, the entire Japanese market appears undervalued. For example, the P/E of the Nikkei index has now fallen to only 11x, while the JASDAQ P/E is 12x. Meanwhile, Japan remains the only country in the world still continuing with a policy of qualitative and quantitative easing. The yield on the 10-year JGB remains around 0%. In other words, the equity risk premium is now about 8-9%, making Japan one of the most undervalued markets in the world.

If we are right about the normalization of monetary policy and consequently about a return to ordinary market cycles then this is a time for stock pickers, long and short.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating. M&A is likely to pick up, too.

Fixed Income

Being long US Treasuries seems an attractive risk / reward as long as the Fed's tightening is on hold. In fact, leading indicators like housing and autos predict a further weakening of the US economy in which case rates could actually drop, a scenario neither expected or priced in.

USD denominated bond yields appear to have peaked for the medium term and valuations are now back at reasonable levels. The top of the debt cycle could become a predominant theme.

Distressed, a theme for H2 2019? - Credit long/short managers are particularly enthusiastic. 2019 marks the beginning of a two- to four-year period of re-financings in the US corporate bond market. The now higher rates and a slower economic growth are enough for some companies to fall into technical default or for investment grade bonds to be re-priced as junk.

As this unfolds distressed investing plus fundamental bond picking, long and short, could be an attractive place to be.

Emerging Markets Currencies & Debt

A dovish Fed implies a weak USD and an outperformance of Emerging Market assets.

China is at the end of its economic cycle with significant excesses in the credit market. Total debt is about 260% of GDP.[vi] Most of the new credit has been used to finance fixed asset investment, which lead to overcapacity. The rate of return on assets in the state-owned corporate sector has fallen below borrowing costs. 22% of apartments are vacant.[vii] There are 50 ghost cities and construction continues.[viii] Authorities need to strike a fine balance between unwinding the credit bubble and restructuring the economy and preventing a destabilizing economic and financial crisis.

Commodities

Consensus among oil traders seems to be that supply outstrips demand. US shale production growth could have peaked.

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.

Gold should do well with a possible demand overhang.

Asset Allocation

Overweight liquid asset classes to stay flexible and nimble.

Overweight equities since corporate bonds are unattractive in their risk / return and other asset classes are lagging. Geographically, Japanese and Asian equities broadly are valued cheaper than the markets in North America or Europe.

The combination of easier money and a weaker dollar support global credit conditions in the short-term. Later in the year, it is likely that a continued accumulation of inflationary pressures, combined with easing in China, could force the Fed's hand into resuming the tightening campaign.

Shorter-term, equity vol is likely to subside while macro vol (rates and FX) increases. This should be positive for Relative Value strategies.

Roland Eberhard

February 1, 2019[ix]

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[i] A further escalation of the US-China Trade War is unlikely. Still, the US decision to press criminal charges against China's Huawei in late February suggests that relations are not exactly amicable.

[ii] This is a reference not only to the US-China Trade War but to the US Section 232 investigation that will wrap up February 17, which could result in steep tariffs on European cars and car parts. As it seems Trump wants to keep a 25% tariff on light trucks and SUV's.

[iii] Eurozone growth has slowed from 2.8% a year ago to 1.2% in Q4 2018.

[iv] Equinox Partners

[v] 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.

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[vi] Karya November 2018 Newsletter, December 1, 2018

[vii] Bloomberg, November 8, 2018, 'A Fifth of China's Homes Are Empty. That's 50 Million Apartments'; https://www.bloomberg.com/news/articles/2018-11-08/a-fifth-of-china-s-homes-are-empty-that-s-50-million-apartments

[viii] Australian Broadcasting Corporation ABC News, June 26, 2018, ' China's eerie ghost cities a 'symptom' of the country's economic troubles and housing bubble'; https://www.abc.net.au/news/2018-06-27/china-ghost-cities-show-growth-driven-by-debt/9912186

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INPUT FOR STRATEGIC ASSET ALLOCATION

JANUARY 2019

PERSPECTIVES (3-6 MONTHS)

Observations, Markets & News
Leadership matters. When leadership fails, such as it did at 10 Downing Street or in the White House, uncertainty reigns, the worst state for financial markets. So much for December.

Beware of the illusion of certainty: 2018 was a year in which volatility forced its way back. Geopolitics took center stage. Consensus shifted from an idea of global synchronous growth with a healthy rise in rates, to one marked by fears over growth contraction and potential central bank missteps.

As investors we must continually seek to define a wide range of possible outcomes. Successful speculators speak in probabilities of one thing over another. Not one dares to pound the table and state something with absolute certainty. Our job is to figure out what others will do because of their political and financial orientation, in a world that is unknowable, forever changing, and then make money with that.

The market regime in 2019 will likely be significantly different than in 2018. To form an accurate outlook guessing monetary policy and estimating inflation rates are the key variables.

Economies & Monetary Policies
Central Banks started the path back to 'normal', a financial environment outside their direct influence. They believed they would have choices. But the markets sent different signals. In Europe, years of asset purchases and negative rates failed to produce an expansion sufficiently robust to allow for policy normalization.

The transition from quantitative easing to quantitative tightening is likely as painful as a recession to the financial markets, even if it is not to the real economy. But to investors, that distinction will feel irrelevant.

QE has done something much more damaging than Central Banks could have imagined. It changed the very nature of the market, destroying the diversity of the market ecosystem, and making it incredibly vulnerable to the smallest change in the macro environment

Economic conditions are fine, not great, but fine. The lower oil price also helps supporting growth.

Property prices in large city centers could be next: There are way too many cranes in Manhattan, London, Hong Kong and even in 2nd tier towns like Frankfurt or Berlin, even Paris.

In Switzerland the real estate boom is particularly pronounced due to the negative rates. Swiss pension funds make decisions on property yields as if negative rates are going to stay with us for a decade or more, an extremely unlikely scenario.

The current situation for sovereigns was compared to Prince Rupert's Drop[i] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[ii] Q4 2018 was not yet the Dutch tears we reference though.

Politics
In France, austerity is dead. In Germany, Annegret Kramp-Karrenbauer can replace Angela Merkel as chancellor only on a policy of spending. This is the path Europe is on.

In America, General Mattis' departure as Secretary of Defense is a worrying signal, increasing gap risks in geopolitics.

Equities
Interest rate-sensitive sectors should be avoided as long as rates keep on being raised.

If we are right about the normalization of monetary policy and consequently to a return to ordinary market cycles then this is a time for stock pickers, long and short.

Stocks face a dichotomy between good news from corporate earnings and bad news from monetary policy. Equity prices are a three parts equation of discounted future earnings, interest rates and risk premiums. Risk premiums in turn are largely dependent on the degree of uncertainty. While major economies are still growing the growth rate is slowing and USD rates are rising, respectively the Fed is tightening.

Japanese equities offer an attractive risk/return: The TOPIX is priced at a multi-year low in P/E and supported by an accommodative BOJ and a cheap Yen.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating. M&A is likely to pick up, too.

Fixed Income
The top of the debt cycle could become a predominant theme.

Distressed, a theme for H2 2019? - Credit long/short managers are particularly enthusiastic. 2019 marks the beginning of a two- to four-year period of re-financings in the US corporate bond market. The now higher rates and a slower economic growth are enough for some companies to fall into technical default or for investment grade bonds to be re-priced as junk.

As this unfolds distressed investing plus fundamental bond picking, long and short, could be an attractive place to be.

Emerging Markets Currencies & Debt
China is at the end of its economic cycle with significant excesses in the credit market. Total debt is about 260% of GDP.[iii] Most of the new credit has been used to finance fixed asset investment, which lead to overcapacity. The rate of return on assets in the state-owned corporate sector has fallen below borrowing costs. 22% of apartments are vacant.[iv] There are 50 ghost cities and construction continues.[v] Authorities need to strike a fine balance between unwinding the credit bubble and restructuring the economy and preventing a destabilizing economic and financial crisis.

Commodities
Consensus among oil traders seems to be that supply outstrips demand. US shale production growth could have peaked.

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.

Asset Allocation
Overweight liquid asset classes to stay flexible.

Underweight fixed income and credit.

Look for diversifying assets and / or strategies. Implied volatility is likely to move higher before long.

Tail Hedges: The gap risk is high. This is the time to decide on a budget for tail hedges, always long vol and with an attractive risk/return ratio, albeit with a low probability of success. Call us to discuss individual tail hedge ideas.[vi]

We wish you a happy, healthy & successful 2019!

Roland Eberhard
January 3, 2019

[i] Equinox Partners

[ii] 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.

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[v] Australian Broadcasting Corporation ABC News, June 26, 2018, ' China's eerie ghost cities a 'symptom' of the country's economic troubles and housing bubble'; https://www.abc.net.au/news/2018-06-27/china-ghost-cities-show-growth-driven-by-debt/9912186

[vi] Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen. The CHF offers trading opportunities, too.

Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

DECEMBER 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News

We are approaching the top of the debt cycle. This could be the predominant theme of 2019.

For now, corporate profitability remains strong and economic growth is high. Interest rate-sensitive sectors should be avoided as long as the Fed keeps on raising rates.

The main risks are politics and monetary policy. Implied volatility is set to rise as key events approach.

Politics

US-China trade war: The economic impact has yet to hit Asia but the impact deepens. The truce reached by Xi Jinping and Donald Trump is a risk on signal.

In Europe, Brexit and the Italian budget drama are the main risks. Democracy is a messy process. But the economic growth is real (not high, but positive). Southern Europe is coming out of the slump, a slow but still positive development.

Economies & Monetary Policies

The outlook for 2019 calls for a marked slowdown in GDP growth across major economies. Headwinds are capacity constraints, monetary policy normalization, and uncertainty around trade and nearing the end of the business cycle.

Global debt levels are higher, inflation pressures more evident. Protectionist trade policies have increased.

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

Equities

The recent stock market sell-off was likely a correction rather than an economic signal. Since 1934, the market was up every time before and after mid-term elections.[iii]

If we are right about the normalization of monetary policy and consequently to a return to ordinary market cycles then this is a time for stock pickers, long and short.

Stocks face a dichotomy between good news from corporate earnings and bad news from monetary policy. Equity prices are a three parts equation of discounted future earnings, interest rates and risk premiums. Risk premiums in turn are largely dependent on the degree of uncertainty. While major economies are still growing the growth rate is slowing and USD rates are rising, resp. the Fed is tightening.

Japanese equities offer an attractive risk/return: The TOPIX is priced at a multi-year low in P/E and supported by an accommodative BOJ and a cheap Yen.

The biggest EM countries are all engaging in reform while the developed markets are still overly reliant on low interest rates. For macro traders, shorting DM and buying EM looks like a trade with attractive risk/reward.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating. M&A is likely to pick up, too.

Fixed Income

We are nearing the end of the debt super cycle that started in 2009 with the normalization of monetary policy. A debt crisis is an increasingly possible outcome.

The cost of fixed income is being repriced globally, one market after the next. The balance of risks to bond yields relative to market pricing is heavily skewed to the upside.

Short US credit has a favorable risk/return outlook. Even if rates do not go up more than currently priced in (something strongly disputed by many hedge funds) and if inflation does not rise either (also a low probability) credit spreads are likely to widen. Higher rates mean re-financing at higher costs for all companies whose bonds mature in 2020 or beyond (re-financings are usually done a year in advance of maturities). This is not only bad news for high yield issuers but also for companies rated at the bottom end of investment grade.

Emerging Markets Currencies & Debt

China is at the end of its economic cycle with significant excesses in the credit market. Total debt is about 260% of GDP.[iv] Most of the new credit has been used to finance fixed asset investment, which lead to overcapacity. The rate of return on assets in the state-owned corporate sector has fallen below borrowing costs. 22% of apartments are vacant.[v] There are 50 ghost cities and construction continues.[vi] Authorities need to strike a fine balance between unwinding the credit bubble and restructuring the economy and preventing a destabilizing economic and financial crisis.

Commodities

Consensus among oil traders seems to be that supply outstrips demand. US shale production growth could have peaked earlier this year.

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.[vii]

Asset Allocation

Underweight fixed income and credit.

Wise to look for diversifying assets and / or strategies. Implied vol is likely to move higher before long.

Start to allocate towards macro trading, long and short: Longer-term, there are multiple headwinds for asset prices. Currency devaluations and defaults are likely to rise in 2019.

Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen.

Roland Eberhard
December 3, 2018

[i] Equinox Partners

[ii] 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."

[iii] Source: Deutsche Bank

[iv] Karya November 2018 Newsletter, December 1, 2018

[v] Bloomberg, November 8, 2018, 'A Fifth of China's Homes Are Empty. That's 50 Million Apartments'; https://www.bloomberg.com/news/articles/2018-11-08/a-fifth-of-china-s-homes-are-empty-that-s-50-million-apartments

[vi] Australian Broadcasting Corporation ABC News, June 26, 2018, ' China's eerie ghost cities a 'symptom' of the country's economic troubles and housing bubble'; https://www.abc.net.au/news/2018-06-27/china-ghost-cities-show-growth-driven-by-debt/9912186

[vii] Regal Funds Management

Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

NOVEMBER 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News: Inflation Pressure

Get ready for a year-end rally. The bull market in US equities is likely to continue as corporate profitability remains strong. Interest rate-sensitive sectors should be avoided as long as the Fed keeps on raising rates. Emerging Markets are also likely to recover from the major underperformance so far in 2018.

The main risks are politics and monetary policy. Implied volatility is set to rise as key events approach.

A rich environment for macro trading has started in earnest because of momentous changes in the global political and economic backdrop. The rise of nationalism leads to a weakening of global law and order, increasing risks in financial markets. The most important from the standpoint of a macro opportunity set has been the progressive withdrawal by central banks from their heavily distorting and volatility-suppressing direct participation in government fixed income markets.

Politics

US-China trade war: The economic impact has yet to hit Asia but impact deepens. When Xi Jinping will meet Donald Trump on November 30[i] a deal would be a risk on signal.

The outcome of the US election next week amidst a polarized electorate is a known unknown. Even if Dems were to control the House the White House economic policy would likely only be affected next year. 'America First' stands for nationalism, which has historically lead to isolation in the short-term and to wars in the longer-term.

Economies & Monetary Policies

Financial conditions are getting tighter. Stocks face a dichotomy between good news from corporate earnings and bad news from monetary policy.

Economies face narrowing output gaps and rising inflation yet markets continue to expect accommodative central bank policies. Wages are rising in the US, UK, Europe and in Japan. Investors may be underestimating the probability of tighter monetary policy. The risk is that markets respond asymmetrically.

The US economy is accelerating and the US labor market is tight. The US growth outlook for 2019 has strengthened. There are unequivocal signs of cost pressures in terms of both inputs and wages. Inflation will pick up as a result.

The risk is higher for the Fed to hike more, not less than the market has currently priced in. The risks to inflation have become asymmetric.

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]

Equities

The recent stock market sell-off was likely a correction rather than an economic signal. Since 1934, the market was up every time before and after mid-term elections.[iv]

The biggest EM countries are all engaging in reform while the developed markets are still overly reliant on low interest rates. For macro traders, shorting DM and buying EM looks like a trade with attractive risk/reward.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating.

Fixed Income

The cost of fixed income is being repriced globally, one market after the next. The balance of risks to bond yields relative to market pricing is heavily skewed to the upside.

Distressed investing a theme for next year: QE goes into reverse and there are big debt loads on some public and private balance sheets. The Sears default is a major event for distressed investing next year.[v]

USD yields could move substantially higher in order to entice international investors to finance the rising US deficit[vi]: US corporates need to refinance $4 trillion of bonds over the next five years (Wells Fargo Securities, May 9, 2018; $ca. $700 bn in 2018, $750bn in 2019 and $880 bn in 2020). About $3 trillion is investment grade, mostly in the lowest rungs BBB / Baa, with the rest in high-yield. Higher borrowing costs look to coincide with tighter credit conditions. If companies will be forced to refinance at higher rates, credit conditions could erode leading to a vicious circle of more downgrades and pushing bond buyers to seek out better-rated issuers.

Emerging Markets Currencies & Debt

With the election in Brazil behind us risk appetite for EM assets might return. Still, EM currencies with large current account deficits and a large portion of their debt in foreign hands (Turkey & Argentina) have sold off steeply. Countries on borderline of economic weakness could get sucked into the vortex (e.g. Indonesia, South Africa, India, Brazil).

EM debt at a record USD11trn with liquidity at US$4.9trn in 2017.[vii] A rise in USD rates speeded by the turn of QE to being a net negative, could destabilize bond markets globally creating a serious headwind for all fixed-income asset prices.

Commodities

Oil: US shale production growth could peak later this year.[viii] The extension of the OPEC cut through the balance of 2018 cemented a bullish underlying supply/demand balance. Almost all oil capex has been directed toward US shale production.[ix]

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.[x]

Asset Allocation

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Start to allocate towards macro trading, long and short: Longer-term, there are multiple headwinds for asset prices. Currency devaluations and defaults are likely to rise in 2019.

Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen.

Roland Eberhard
November 1, 2018

[i] The next G20 summit in Buenos Aires, Argentina is scheduled on November 30 until December 1, 2018

[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.

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[iv] Source: Deutsche Bank

[v] Sears Holdings filed for Chapter 11 bankruptcy protection on October 15, 2018 with $5 billion debt on the balance sheet.

[vi] Karya

[vii] Bank for International Settlements: between 2010 and 2017 the total value of emerging market debt securities outstanding more than doubled from US$5trn to around US$11trn. Yet over the same period, according to the Emerging Market Traders Association, trading volumes in emerging market debt fell, sliding from more than US$6.5trn in 2010 to US$4.9trn in 2017.

[viii] Rig count in the Permain basin has flatlined around 460 with new production at 620 brl/day to a new production of 285'000 brl/day. Legacy decline is over 300'000 brl/day implying that Permian output could fall in the next few months. Source: Horseman, 25.07.2018

[ix] Horseman Global, BBL Commodities

[x] Regal Funds Management

Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

OCTOBER 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News: Inflation Pressure

The US has a positive real interest rate for the first time in a decade with the Fed at 2% and PCE inflation[i] at 1.5% in August. US interest rates rose on the back of a strong employment market, rising wage data, and bullish sentiment data. This trend is likely to continue for several months.

We expect the global outlook to remain extremely challenging for the EMs and a deterioration in the corporate debt market could follow soon with the prospect of interest-rate normalization and the end of an unprecedented ten-year monetary stimulus cycle in the developed economies, which continue to perform robustly. Higher USD rates are inherently bad for EM where significant debt is issued in USD.

Implied volatility is set to rise as key events approach.

Politics

US-China trade war: The two largest economies are on contrasting economic trajectories. The US embarks on monetary tightening to prevent its economy from overheating in the context of the lowest unemployment rate since 2000 and GDP growth set to be the fastest since 2005. The Chinese government has moved toward more flexible fiscal and credit policies to avert an economic slowdown, which could be transformed into a hard landing by the impact of Trump's tariffs.

Risk premia rises because of Fed policy and due to a White House that is imposing trade tariffs on even the closest allies. 'America First' stands for nationalism, which has historically lead to isolation in the short-term and to wars in the longer-term. Each passing month highlights how the market regime has changed, with rising interest rates, the culmination of Central Bank asset purchase programs, increasing geopolitical tensions, and trade wars increasing uncertainty and driving volatility higher.

Economies & Monetary Policies

Economies face narrowing output gaps and rising inflation yet markets continue to expect accommodative central bank policies. Wages are rising in the US, UK, Europe and in Japan. Investors may be underestimating the probability of tighter monetary policy. The risk is that markets respond asymmetrically.

The US economy is accelerating and the US labor market is tight. The US growth outlook for 2019 has strengthened. There are unequivocal signs of cost pressures in terms of both inputs and wages. Inflation will pick up as a result.

The risk is higher for the Fed to hike more, not less than the market has currently priced in. The risks to inflation have become asymmetric.

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]

Equities

Despite tightening policy and slowing growth equities have not yet meaningfully responded and remain near all-time highs.

Mining and mining services stocks generally outperform when bond yields are rising. Tech companies with growing revenue and earnings at high levels are independent of economic growth.

We favor healthcare and biotech stocks where price/sales ratios remain close to historic lows and a near record number of companies trade below 2x cash while drug innovation is accelerating.

Fixed Income

The cost of fixed income is being repriced globally, one market after the next. The balance of risks to bond yields relative to market pricing is heavily skewed to the upside.

USD yields could move substantially higher in order to entice international investors to finance the rising US deficit[iv]: US corporates need to refinance $4 trillion of bonds over the next five years (Wells Fargo Securities, May 9, 2018; $ca. $700 bn in 2018, $750bn in 2019 and $880 bn in 2020). About $3 trillion is investment grade, mostly in the lowest rungs BBB / Baa, with the rest in high-yield. Higher borrowing costs look to coincide with tighter credit conditions. If companies will be forced to refinance at higher rates, credit conditions could erode leading to a vicious circle of more downgrades and pushing bond buyers to seek out better-rated issuers.

Emerging Markets Currencies & Debt

EM show symptoms of a broader weakness in the structure of global financial markets. Negative turn in EM debt since mid-April.

EM currencies with large current account deficits and a large portion of their debt in foreign hands (Turkey & Argentina) have sold off steeply. Countries on borderline of economic weakness could get sucked into the vortex (e.g. Indonesia, South Africa, India, Brazil).

EM debt at a record USD11trn with liquidity at US$4.9trn in 2017.[v] A rise in USD rates speeded by the turn of QE to being a net negative, could destabilize bond markets globally creating a serious headwind for all fixed-income asset prices.

Commodities

Oil: US shale production growth could peak later this year.[vi] The extension of the OPEC cut through the balance of 2018 cemented a bullish underlying supply/demand balance. Almost all oil capex has been directed toward US shale production.[vii]

Demand in rare earths such as lithium, cobalt and graphite is exploding because of increasing popularity of electric vehicles.[viii]

Asset Allocation

With so many key events in the coming months regarding US-China trade relations, the Italian budget negotiation, Brexit, Iran sanctions, and the US midterm elections the benign pricing of risk premia strikes us as a bit complacent.

Wise to look for diversifying assets and / or strategies. Implied vol is likely to move higher before long. Merger Arb or event driven strategies profiting from M&A offer attractive risk/rewards. Examples for hedges are long Japanese yen as a general risk aversion trade, short Australian dollar as a hedge against a China slowdown, short US high yield and CMBS due to deteriorating credit quality and an increase in borrowing rates, and short Italian government bonds as a hedge to escalating European political risk. Short sovereign debt or CDS on corporates could profit if either rates rise and/or spreads widen.

Roland Eberhard

October 4, 2018

Madala

[i] PCE Inflation stands for personal consumption expenditure price index (PCEPI) and is a good measure of US inflation as it tracks the change in prices of goods and services purchased by consumers.

[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.

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[vii] Horseman Global, BBL Commodities

[viii] Regal Funds Management

Madala

INPUT FOR STRATEGIC ASSET ALLOCATION

SEPTEMBER 2018

PERSPECTIVES (3-6 MONTHS)

Observations Markets & News: Inflection Point

In only two months the share price of Amazon has increased by 18.4% (YTD +72.1%) and Apple by 23.0% (YTD +34.5%). Facebook dropped by -19% in one day.[i] This is reminiscent of the tech bubble in the 90s.

Developed markets have seen a breakdown of the Phillips Curve[ii] link between inflation and unemployment. Inflation, rising in the US and falling in Europe, is a key risk factor.

Diminishing central bank and market liquidity are magnifying any shock. Identifying these potential shocks and hedging them becomes important.

Implied volatility is set to rise as key events approach.

Politics

US-China trade war: The two largest economies are on contrasting economic trajectories. The US embarks on monetary tightening to prevent its economy from overheating in the context of the lowest unemployment rate since 2000 and GDP growth set to be the fastest since 2005. The Chinese government has moved toward more flexible fiscal and credit policies to avert an economic slowdown, which could be transformed into a hard landing by the impact of Trump's tariffs.

Risk premia rises because of Fed policy and due to a White House that is imposing trade tariffs on even the closest allies. 'America First' stands for nationalism, which has historically lead to isolation in the short-term and to wars in the longer-term. Each passing month highlights how the market regime has changed, with rising interest rates, the culmination of Central Bank asset purchase programs, increasing geopolitical tensions, and trade wars increasing uncertainty and driving volatility higher.

Economies & Monetary Policies

Developed world financial conditions are broadly tightening. Cyclically leading economies (US, UK, Canada) have started tightening with rate hikes to fight inflationary pressures and Australia, ECB and Japan tighten via slowing of liquidity injections.

The US economy is accelerating and the US labor market is tight. The US growth outlook for 2019 has strengthened. There are unequivocal signs of cost pressures in terms of both inputs and wages. Inflation will pick up as a result.

The risk is higher for the Fed to hike more, not less than the market has currently priced in. The risks to inflation have become asymmetric.

The impact of deregulation on the financial sector is starting to have an impact. It will counteract the Fed's tightening.

In Europe, consumer spending has slowed or started to fall in Germany, France, Spain and Italy.[iii] If signs of rising inflation stop firms will delay hiring and postpone capital spending.

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

Equities

Despite tightening policy and slowing growth equities have not yet meaningfully responded and remain near all-time highs.

Mining and mining services stocks generally outperform when bond yields are rising. Tech companies with growing revenue and earnings at high levels are independent of economic growth.

Fixed Income

The cost of fixed income is being repriced globally, one market after the next. We have reached the end of QE and zero interest rate policy in the US.

USD yields could move substantially higher in order to entice international investors to finance the rising US deficit[vi]: US corporates need to refinance $4 trillion of bonds over the next five years (Wells Fargo Securities, May 9, 2018; $ca. $700 bn in 2018, $750bn in 2019 and $880 bn in 2020). About $3 trillion is investment grade, mostly in the lowest rungs BBB / Baa, with the rest in high-yield. Higher borrowing costs look to coincide with tighter credit conditions. If companies will be forced to refinance at higher rates, credit conditions could erode leading to a vicious circle of more downgrades and pushing bond buyers to seek out better-rated issuers. A positive is the Republican tax overhaul with the new legislation leaving some firms with more cash.

Emerging Markets Currencies & Debt

EM show symptoms of a broader weakness in the structure of global financial markets. Negative turn in EM debt since mid-April.

EM currencies with large current account deficits and a large portion of their debt in foreign hands (Turkey & Argentina) have sold off steeply. Countries on borderline of economic weakness could get sucked into the vortex (e.g. Indonesia, South Africa, India, Brazil).

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Commodities

The Baltic Dry Index corrected by -9.6% in August.[viii]

Oil: US shale production growth could peak later this year.[ix] The extension of the OPEC cut through the balance of 2018 cemented a bullish underlying supply/demand balance. Almost all oil capex has been directed toward US shale production.[x]

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Asset Allocation

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Roland Eberhard
September 3, 2018

Madala

[i] Closing prices of FB.O were $217.50 on July 25 and $176.26 on July 26 with the stock falling further in the following two trading days.
[ii] https://en.wikipedia.org/wiki/Phillips_curve: "Stated simply, decreased unemployment, (i.e., increased levels of employment) in an economy will correlate with higher rates of wage rises."
[iii] Annual retail sales are now growing/shrinking at 0.8%, -1.6%, -0.4% and -0.8%, respectively

[iv] Equinox Partners

[v] 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.
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[viii] close of 1'579 on August 31 vs 1'747 on July 31
[ix] Rig count in the Permain basin has flatlined around 460 with new production at 620 brl/day to a new production of 285'000 brl/day. Legacy decline is over 300'000 brl/day implying that Permian output could fall in the next few months. Source: Horseman, 25.07.2018

[x] Horseman Global, BBL Commodities

[xi] Regal Funds Management