The Swiss Merchant Bank

Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

The squeaky wheel gets the grease: Fear has financial markets firmly in her grip.[i] The spiky-crowned new coronavirus has capsized civilization and unleashed an unparalleled angst. The panic is globalized, and portfolios went into freefall.

The only precedent we can refer to is the 1918 influenza pandemic.[ii] Sadly, the human tragedy displays resemblance to 2020. The prediction is that the coronavirus will come and go in waves with declining peaks akin to the influenza.[iii]

Two months ago, we wrote that "should the virus lead to a deep, long-term economic fallout the tactical asset allocation would need to be changed quickly and drastically." We acted accordingly in early March.

Markets are in a transitory period, a change of paradigm to the market regime that lasted since March 2009. A new market regime will emerge at some point, most likely somewhere between May and July. Nobody knows how long it will last and at least the beginning will be marked by uncertainty.

Politics, Economies & Monetary Policies

After four decades of disinflation we are now certain of massive money printing. This could be the turning point for inflation to rise which would require a fundamentally different approach.[iv]

In the space of just a few weeks the world changed from an outlook of modest economic growth to now having to predict the unknown. Recessions are priced in.

Equities

The countries that have fared best are those that have been fastest to test, track and isolate areas of infection, giving them a good idea of the size of the outbreak and the best means to flatten the curve of its spread. These will be the countries and sectors where growth will rebound strongly.

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

Fixed Income & Credit

We have come to rely on long-term government bonds until rates dropped to negative first in CHF, then in EUR and now in USD, too. In corporate investment grade bonds the time might be right to rebalance and crystallize profits.

The US energy industry, already the largest component of the US high yield market, faces a solvency crisis after Saudi Arabia and Russia declared an oil price war. It will take a few weeks before we see bankruptcies but they are almost inevitable. This will then mark the beginning of a distressed investing cycle.

The real estate market was grossly over-supplied with credit. Leveraged loans, mortgage backed securities and commercial properties are facing the day of reckoning. REIT's that invested in these markets imploded.[v] The same happened to stock prices of levered shale oil companies.

What is perceived as a strong, balanced system one day could blow up the next just like Prince Rupert's Drop ("larme de verre").[vi]

Commodities

Gold remains in an upward trend but during the liquidation wave it was sold like everything else. The metal has no credit risk and infinite duration. The debasement of fiat currencies has further added to the attractiveness of gold.

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

We refrain from expressing views on oil or other energy markets. Exogenous factors offer a wide range of scenarios.

Alternative Funds

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

Asset Allocation

Having a robust investment strategy based on a foundation of strong principles is key. Long term, time in the market outperforms timing the market. Better to follow a disciplined process than be driven by swings of momentum.

Don't take big bets or catch falling knives: As fiduciaries we need to focus on wealth preservation. This is the time for high-quality, broadly diversified portfolios that have staying power.

We keep cash at the upper levels within strategic limits and bonds at the minimum levels. We are neutral on equities.

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.

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

Consider adding tail hedges. Regard the Swiss Franc as an asset class. Alternatively, add active strategies with uncorrelated returns and convexity.

Roland Eberhard

April 1, 2020[vii]

[i] "The Kicker" (c. 1870) by Josh Billings:

I hate to be a kicker,
I always long for peace,
But the wheel that squeaks the loudest,
Is the one that gets the grease.

[ii] Ever wondered why the 1918 flu pandemic was referred to as "Spanish flu"? No, it's not because it started there. It is because Spain was neutral during WW I and thus had a free press. Spanish media reported about the outbreak whereas war countries did not. One thesis is that the flu started in Kansas. Other historians put the origin to the UK, China or even Austria.

[iii] A good book to read is "*The Great Influenza: The Story of the Deadliest Pandemic in History*" by historian John M. Barry published in 2004. Last week, Barry was interviewed by David Remnick from The New Yorker: https://www.newyorker.com/culture/video-dept/a-historians-view-of-the-coronavirus-pandemic-and-the-influenza-of-1918

[iv] Much has been written about the subject of money printing and inflation. Edward Chancellor, author of '*Devil Take the Hindmost: A History of Financial Speculation'*, 1999, published a thoughtful article on March 24, 2020 ['*Breakingviews - Chancellor: Coronavirus crash is inverted bubble'*, Reuters, https://uk.reuters.com/article/us-health-coronavirus-markets-breakingvi/breakingviews-chancellor-coronavirus-crash-is-inverted-bubble-idUKKBN21B26B] in which he argues that "a severe global supply shock is going to be met by fiscal activism, supported by easy money. If history is a reliable guide, investors start preparing for inflation to return with a vengeance."

[v] Year-to-date return for Q1 2020 of selected REIT's:

-33%	Boston Properties Inc
-42%	Federal Realty Investment Trust
-53%	Kimco Realty Corp
-63%	Simon Property Group Inc
-63%	Site Centers Corp
-79%	Macerich Co
-80%	Michaels Companies Inc
-82%	AG Mortgage Investment Trust Inc
-83%	Pennsylvania Real Estate Investment Trust

[vi] 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."