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The Swiss Merchant Bank

# Baer Necessities

## June 2020

## Perspectives for Strategic Asset Allocation

**Observations, Markets & News**

"A riot is the language of the unheard," said Martin L. King Jr.[i] America is burning: Seven days of protests in over 75 cities, curfews imposed in nearly 40 cities, the National Guard activated in 15 states, violence across the land. George Floyd's murder rocks America to the core.

Over 41 million Americans claim benefits. The unemployment rates are 16.7% for Black Americans, 18.9% for Hispanics and 40% (!) for low-wage workers.[ii] - Why then did markets rally?

A stark dichotomy between financial markets and the real economy is unfolding. Once the market realizes that the Fed will not be able to support asset prices through the current economic downturn selling momentum could be vicious.

**Politics, Economies & Monetary Policies**

The world economy awakens. It was not a spindle that put us to sleep but decrees by concerned politicians. As we go about our business the true extent of the impact will be visible.[iii]

It could emerge that China is growing into a V-shaped recovery. Continental Europe might look more like the Nike swoosh logo. The question is on the shape of the US recovery.

A new cold war between America and China is a dominant concern. It has the potential to change supply chains in a major way.[iv] Until November's election the relation will be tense and the countries on the brink of war. Even if Democrats were to win big in November all US politicians sense an unease that America was growing too dependent on China.

The European Recovery Fund is the backdoor to a fiscal union. The likely size will be EUR750bn of which EUR500bn in grants and EUR250bn in loans.[v] To put the size in perspective this could amount to 3.2% of Italian GDP for Italy alone.[vi] Once confirmed, this will be a major support for European markets.

In China, it looks like infrastructure and building (both Government sponsored) will be the flagship sectors to lead the recovery followed by consumer spending in essentials.

The pandemic has precipitated the implementation of "Modern Monetary Theory", the aggressive fiscal expansion financed by central banks. The consequences, intended and unintended as they may be, are difficult to predict. What is perceived as a strong, balanced system one day could blow up the next just like Prince Rupert's Drop ("larme de verre").[vii]

**Equities**

A prolonged period of US economic underperformance is becoming a plausible scenario. Outside the US tech giants question whether the percentage allocation to US equities still makes sense. Consider an allocation to Japan and China:

Japanese non-financial stocks look attractive: Valuations are low, no debt, positive cash flow and traded in a historically cheap currency. The total amount of cash on their books is close to the market capitalization of the entire Topix index.

The Shanghai Stock Exchange is working towards the launch of eastbound trading for the Shanghai-London Stock connect in 2020. Eligible companies listed on the London Stock Exchange may issue China depositary receipts and apply to list on the SSE's main board.[viii] Flow into Chinese markets is likely to increase. Consider an early strategic allocation to China.

**Fixed Income & Credit**

Fed liquidity cannot save companies from bankruptcy and thus defaults on their debt. Put differently, it is hard to avert bankruptcies by simply lending more money.

The US convertible bond market valuations are as cheap as they have been since 2008. This creates fantastic opportunities for Convertible Bond Arbitrage.

**Commodities**

We suggest rebalancing the commodity allocation. Gold remains in an upward trend. Precious Metals remain a complementary asset class. The small negative carry from holding physical metals has become irrelevant.

**Alternative Funds**

We expect dispersion to remain elevated. Such an environment favors equity long/short strategies. A new cycle for distressed investing has started with major defaults announced in May.[ix] CB Arbitrage is attractive.

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**

An abnormally wide range of potential outcomes calls for reinforced diversification across various risk factors. We are actively looking to add tail hedge strategies.

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

Roland Eberhard

June 2, 2020[x]

[i] September 27, 1966: 'The Other America' speech held at Stanford University. Quote of the passage that was relevant then and remains relevant today:
*"Certain conditions continue to exist in our society, which must be condemned as vigorously as we condemn riots. But in the final analysis, a riot is the language of the unheard. And what is it that America has failed to hear? It has failed to hear that the plight of the Negro poor has worsened over the last few years. It has failed to hear that the promises of freedom and justice have not been met. And it has failed to hear that large segments of white society are more concerned about tranquility and the status quo than about justice, equality and humanity. And so in a real sense our nation's summers of riots are caused by our nation's winters of delay. And as long as America postpones justice, we stand in the position of having these recurrences of violence and riots over and over again. Social justice and progress are the absolute guarantors of riot prevention."*

[ii] A figure also likely to rise. Jerome Powell, Federal Reserve chair, said in remarks given on Mary 13, 2020 that 40% of households making under $40'000 a year lost a job in March: "This reversal of economic fortune has caused a level of pain that is hard to capture in words."

[iii] Here is the gloomy scenario: By the time this pandemic and its economic consequences will be all over the poor will be poorer, the middle class smaller, the countries horrifically in debt, unemployment much higher than before and the top 1% will be largely fine.

[iv] Doubters should read the paper published by the White House on May 20, 2020 entitled "United States Strategic Approach to the People's Republic of China" which can be found at: https://www.whitehouse.gov/wp-content/uploads/2020/05/U.S.-Strategic-Approach-to-The-Peoples-Republic-of-China-Report-5.20.20-1.pdf
The opening paragraph includes the following: "Beijing openly acknowledges that it seeks to transform the international order to align with CCP (Chinese Communist Party) interests and ideology. The CCP's expanding use of economic, political and military power to compel acquiescence from nation states harms vital American interests and undermines the sovereignty and dignity of countries and individuals around the world."

[v] Amounts as proposed by European Commission President Ursula von der Leyen on May 27, 2020. Key is that the proposal is supported by Germany, the traditional opponent of mutualization of debt in the Eurozone. The approval rating of Merkel's CDU party surged from 27.5% in February to 38% in May. This gives Germany negotiation power.
The crucial innovation is that the European Union will issue bonds in its own name and guaranteed by its own revenues. By nature, this implies a fiscal federation. The European Commission's budget should increase from 1.2% to 2% of EU gross national income. The extra income amounts to about €180bn annually.
This year, the EU issues bonds to cover the costs of the coronavirus lockdown. In future, the EU could use the mechanism for other purposes the Commission sees fit, such as carbon emissions, low emission energy, etc.

[vi] As calculated by Jefferies' European fixed income strategist, Mohit Kumar, published on May 28, 2020.

[vii] 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."

[viii] See more at https://www.lseg.com/markets-products-and-services/our-markets/shanghai-london-stock-connect

[ix] High profile names include Hertz (with liabilities of $24.35bn), J.C. Penney ($8.0bn) and Intelsat ($16.8bn). May 2020 has seen most large US bankruptcy filings since 2009 (counting Chapter 11 and 7 and a minimum liability of $50mn).