

# Baer Necessities

July 2020

## Perspectives for Strategic Asset Allocation

### Observations, Markets & News

Today, Germany assumes the EU Council Presidency, the last led by Angela Merkel who will guide the courageous recovery plan. If she (and Macron) gets her way it will be a major support for European markets. The flagship European Recovery Fund is the backdoor to a fiscal union. The likely size will be €750bn of which EUR500bn in grants and EUR250bn in loans.<sup>i</sup> This could amount to 3.2% of GDP for Italy alone.<sup>ii</sup>

The 2<sup>nd</sup> focal point in asset allocation should be China and conceivably Japan. Chinese equities could be at the beginning of a secular bull market. China seems to be working towards financial independence. Their newly created pension funds will invest locally. Chinese companies are delisting from the USA and listing anew in Hong Kong. China has the largest consumer market, the highest savings market, the economic momentum and the earnings momentum.<sup>iii</sup>

Infrastructure is China's large foundation for its recovery, perhaps for decades to come. This includes digital facilities, a novelty for many Western nations, with 5G base stations, vehicle charging stations, data centers, artificial intelligence and the industrial internet. These facilities have been termed 'New Infrastructure' in which investment this year alone might amount to RMB 3 trillion.

### Politics, Economies & Monetary Policies

U.S. pending home sales jumped a record 44.3% in May, the largest increase since the series started in 2001. The housing market could emerge more quickly from the recession thanks to historic low interest rates leading other parts of the economy.

Monetary data is signaling a stabilization in the economic downturn guiding financial markets. G7 May YOY broad money growth is the highest since 1973 and narrow money growth the highest since WW II.<sup>iv</sup>

We are in the early stages of the "Modern Monetary Theory", the pugnacious 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").<sup>v</sup>

### Equities

Remarkably, US equities rose in June against a headwind of outflows of \$52bn<sup>vi</sup>. Small-caps look like an alluring choice. They tend to outperform large caps in the recovery stage.

The baseline is a persistent positive momentum for equities in Europe and North America. Headwinds are likely each time an uptick in hospitalizations is reported.

We continue to overweigh Japan and China, a call supported by strong fundamentals. Japanese non-financial stocks have some way to go.

A green light to green investments: In terms of sector allocation consider that the energy transition towards less emissions is a big industrial driver. Catching this trend early means to be ahead of the money flow to generate alpha.

### Fixed Income & Credit

Austria issued its second 100-year bond with a zero coupon.<sup>vii</sup> The price rose by nearly 16% in the first three weeks of trading and the yield dropped to 0.66%. What is your expected inflation rate for Austria for the next century? - Western government bonds are no longer a long-term store of value.

Chesapeake Energy Corp filed for Chapter 11, becoming the largest U.S. oil and gas producer to seek bankruptcy protection. The filing marks the beginning of a new cycle in distressed investing.

### Commodities

Our bullish stance has been profitable so far. Copper continues its long-term uptrend signaling a strong economic recovery.

Gold, the oldest reserve of value, remains in an upward trend. Precious Metals remain a complementary asset class.<sup>viii</sup>

### Alternative Strategies

An elevated equity dispersion favors long/short strategies. A new cycle for distressed investing has started. CB Arbitrage is attractive as are many other alternative strategies.

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

As long-term bond yields continue to compress, equities remain relatively inexpensive. Ongoing volatility offers good opportunities to profit from short-term price dislocations.

An abnormally wide range of potential outcomes calls for reinforced diversification across various risk factors.

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

Roland Eberhard

July 1, 2020<sup>ix</sup>

<sup>i</sup> 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 70% in May, which gives Germany negotiation power. See also <https://www.theguardian.com/world/2020/jun/06/no-european-leader-is-safe-as-public-lose-faith-in-coronavirus-responses>. 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.

<sup>ii</sup> As calculated by Jefferies' European fixed income strategist, Mohit Kumar, published on May 28, 2020.

<sup>iii</sup> Guo Shuqing, Chairman China Banking & Insurance Regulatory Commission deserves special mention. On June 17, 2020 he made a strong point: "Some people say domestic debt is not debt but external debt is debt. For the United States, even external debt is not debt. This seems to have been the case for quite some time in the past but can it really last for a long time in the future? China cherishes the conventional monetary and fiscal policies very much. We will not engage in flooding the system, nor will we engage in deficit monetization and negative interest rates."

See also: <https://www.marketscreener.com/news/China-Won-t-Monetize-Fiscal-Deficit-Top-Financial-Regulator-Says--30787848/>  
<https://www.nytimes.com/reuters/2020/06/18/world/asia/18reuters-china-finance-stimulus.html>

<sup>iv</sup> Source: Simon Ward, Money Moves Markets (<http://moneymovesmarkets.com>);

Quote: "The cycle analysis here yields an opposite conclusion: rather than acting as a catalyst for a new period of cyclical weakness, the virus shock has magnified but probably marks the end of a pre-existing downswing dating back to early 2018. Key cycles are now shifting from acting as a headwind to providing a tailwind to global economic momentum. ... A common misperception is that a business investment cycle recovery requires a rebound in "animal spirits". This usually occurs later in the upswing. Replacement capital spending plays an important role in the initial revival: such spending is postponed during the downswing, creating a reservoir of pent-up demand that is released as economic conditions stabilise."

<sup>v</sup> 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."

<sup>vi</sup> Source: Eikon Thomson Reuters on June 30, 2020. Money flow over the past month in North America was \$72.08bn into bonds and \$31.53bn into money market with a net outflow of \$-51.91bn out of equities

<sup>vii</sup> The zero coupon bond matures on June 10, 2120. (ISIN XS2187711572)

<sup>viii</sup> Gold had its best quarter in four years topping \$1'800/ounce representing a price increase of 13.5% for Q2 2020.

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