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Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News
The energy component of the S&P 500 has dropped to 2.2%, a new record. Crude oil stockpiles rose sharply because of widespread quarantines and travel restrictions. This excess capacity has led to cheap oil prices. The contango is low implying that the market expects a structural oversupply for years to come.[i] The gap risk in oil prices is up, though.

What if oil demand grows strongly but non-OPEC production growth is flat?[ii] The oil price would rise, profit margins for energy companies would increase, and inflation, at least in the short-term, would accelerate. The current dividend yield of oil stocks is attractively high in a range from 6% to about 9%.[iii] We think it is time to have a close look at the energy component of the strategic asset allocation. The probability is in your favor.

Politics, Economies & Monetary Policies
With regards to the virus Europe did not learn from China, New York did not learn from Europe, and the rest of the USA did not learn from New York. The same pattern could repeat itself for the economic recovery: China's growth is back on track. Economic activity in Europe starts recovering and will be strengthened because storage and inventories are low. Once America's growth kicks in the recovery could be swift and the demand for oil strong.

Biden scored his first touchdown when announcing his VP candidate Kamala Harris. With the two conventions behind us, we are entering the frenzy period of this year's US election.

The US “decoupling” of the US and Chinese economies is likely to continue independent of who wins in November. What began with a trade war has now spread to almost all aspects of the relationship, with the pandemic accelerating the process. This change of paradigm could define geopolitics for years to come.

Still, marginal economic growth is most likely to come from Asia. Most investors are structurally underexposed to China. As decoupling intensifies direct investments in countries and sectors profiting from China's growth are key.

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”).[iv]

Equities
The implied volatility of stocks remains high: The current level for the S&P 500 as expressed by the VIX is at over 25%, significantly above the mean for the last few years. In contrast, the realized one-month volatility of the S&P 500 has fallen below 10%. Usually, this attracts systematic strategies to buy equities, which could be a support of the index into September.

Apple is worth about 112% of the entire Russell 2000 Index.[v] Apple's market capitalization more than doubled in a mere two years since it became the first publicly listed U.S. company with a USD1 trillion stock market value and now is the first to reach the USD2 trillion mark.

Fixed Income & Credit
We have added Chinese sovereign and corporate debt in spring. The default risk on Chinese government bonds is as low as for U.S. treasuries but the average yield differential is about 2.5%.[vi] Plus, the yuan is a strong currency.

China's policy is to increase the renminbi's use in international trade and as a reserve currency. For instance, Russia is paid in Euros for over half of her exports to China.[vii] To achieve China's goals Beijing will need to show a strong credit rating, a liquid market and a stable exchange rate. China could actually benefit from letting the yuan rise in that it would accelerate the goal of making the yuan used more broadly in trade and in central bank reserves.

Commodities
As gold breaks out to reach new highs we remain constructive but do become more cautious. Long gold has become a crowded traded. Our initial view in January 2019 was based on a supply/demand imbalance. While this seems to persist a significantly weaker dollar is now a major factor.

Alternative Strategies
In order to hedge against risks in the macroeconomic and geopolitical outlook, not to mention the pandemic itself, we suggest adding long vol biased alternative strategies.

We are seeking to add structural, asymmetric downside protection against a broad correction in global financial markets: As equity markets reach new highs complacency returns across asset classes. That's human nature.

Asset Allocation
An abnormally wide range of potential outcomes calls for reinforced diversification across various risk factors. If possible, add downside protection in form of tail risk hedges.

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
September 1, 2020[viii]

[i] The market is in contango when forward prices of oil futures contracts are higher than the spot price. Currently, the spot price of Brent crude is around USD45/barrel and the highest price is around USD53/barrel in 2025. The break-even price for most non-OPEC producers is higher than USD50/barrel.

[ii] Goldman Sachs wrote: "… we have entered a structural phase of no non-OPEC growth." see also: https://www.cnbc.com/2020/07/02/goldman-sachs-oil-demand-to-return-to-pre-pandemic-levels-by-2022.html

[iii] Dividend yield for the largest oil majors sorted by revenues:

7.7% Sinopec

8.5% Royal Dutch Shell

10.3% BP

8.8% Exxon Mobil

8.1% Total

8.3% Gazprom

6.0% Phillips 66

6.1% Chevron

[iv] Wikipedia: "Prince Rupert's Drops (also known as Dutch tears) are toughened glass beads created by dripping molten glass into cold water, which causes it to solidify into a tadpole-shaped droplet with a long, thin tail. These droplets are characterized internally by very high residual stresses, which give rise to counter-intuitive properties, such as the ability to withstand a blow from a hammer or a bullet on the bulbous end without breaking, while exhibiting explosive disintegration if the tail end is even slightly damaged. In nature, similar structures are produced under certain conditions in volcanic lava.

The drops are named after Prince Rupert of the Rhine, who brought them to England in 1660, although they were reportedly being produced in the Netherlands earlier in the 17th century and had probably been known to glassmakers for much longer. They were studied as scientific curiosities by the Royal Society and the unravelling of the principles of their unusual properties probably led to the development of the process for the production of toughened glass, patented in 1874."

[v] At yesterday's closing Apple's market capitalization was USD 2.135 trillion and the Russell 2000 total market capitalization was USD 1.91 trillion. The Russell 2000 Index is the index of the smallest 2'000 stocks in the Russell 3000 Index. Put differently, these 2'000 companies combined are worth only 89% of Apple.

[vi] Yesterday, the yield differential on the ten year debt was 2.31%:China 10Y 2.9508% vs. USA 10Y 0.6390%

[vii] Natasha Doff and Andrey Biryukov, August 13, 2020, Bloomberg: 'Russia Ditches the US Dollar for Bulk of Its Exports to China': https://www.bloomberg.com/news/articles/2020-08-12/russia-ditches-the-dollar-for-bulk-of-its-exports-to-china