Baer Necessities

January 2021
Perspectives for Strategic Asset Allocation

Observations, Markets & News

A breathless year lies behind us. The post-pandemic boom is the current overarching theme. To conquer the effects of a transitory natural disaster, governments have brought about structural shifts in policy. The pandemic is hopefully over soon, but the programs will stay with us for a while. Nowhere is this more true than in America with an aggressive Chairman Powell at the Fed and a dovish Yellen as Treasury Secretary.

In Europe, the Recovery Fund is a financial package of €1.8 trillion. Each country will have its individual plan, but at least 37% must support the green transition, and at least 20% is invested in digital transformation.[i] A surge in construction activity is a certainty with so much infrastructure spending, which is good news for commodity prices.

The new decade has started on an entirely new footing. We are amidst the most significant paradigm shift since 1971 when the US went off the gold standard and the oil shock after the Yom Kippur war in 1973.[ii]

Politics, Economies & Monetary Policies

Rising inflation is likely the most significant risk to financial markets. However, high levels of unemployment and excess capacity after the Covid-19 crisis will restrain inflation, at least in 2021.

The single pivotal risk to equities is monetary tightening. The good news, though, is that this is nowhere in sight. There will be a revival in Capex in the post-pandemic world. Saving rates will fall globally. But, the broad, deflationary backdrop has not changed.

With Brexit behind us, Europe's financial center is now outside its immediate borders.

China's new digital currency could inspire a shift in capital flows.[iii] If and how to integrate cryptocurrencies is a question we as investors need to address as the technology matures.

Equities

The consensus view is bullish equities, and thus a bit dangerous. So far, stocks are tracking the mania of the 1990s. The average annual return for the S&P500 was 30% from 1996 until 1999, with some years as high as 50% or more.

The right approach is probably a barbell strategy with concentrations on growth leaders on one side and on value stocks on the other. In particular, we like companies with stable cash flow as a proxy to bond exposures. Last year, our strategy for Swiss Dividends has yielded attractive results in a currency with negative or zero yield across most corporate bonds. Our portfolio's current average dividend yield is 4.7%.[iv]

Sector valuation dispersion remains unusually high and offers opportunities. Meanwhile, small-cap and value stocks remain attractive. Sectors that suffered greatly from the pandemic, like hospitality and airlines, have tremendous hidden value.

Our case for integrating Chinese equities into the asset mix received a boost this week when the EU and China signed their free-trade agreement after seven years of negotiations.[v] The EU policy is in stark contrast to the US policy on China.

Fixed Income & Credit

The Covid-19 crisis has extended the debt supercycle. The policy response to the pandemic has extended the runway for the corporate credit cycle by some years. With borrowing rates staying at such depressed levels, corporate leverage will rise to a new higher equilibrium.

We underweight corporate bonds, investment grade, and high yield. In the US, municipal bonds and MBS could perform well. We like inflation bonds, even if only as a hedge.

However, we need to be cautious. What is perceived as a robust and balanced system one day could blow up the next just like Prince Rupert's Drop (“larme de verre”).[vi]

Commodities

The stage is set for a cyclical increase in commodity prices: Stimulus packages targeting the electrification of transport and the growing use of renewable energy boost demand. Rising demand for solar panels will naturally increase the demand for silver, at least as long as solar panels are not produced more efficiently.

Several years of low prices for many commodities forced producers to curb spending, which is now constraining supply. The oil industry is a prime example.

By late 2021 we can hopefully make a judgment call on whether this cyclical rise of commodity prices is structural.

Alternatives

We use specific alternative strategies as a proxy for what hitherto was the bond allocation. Our focus remains on truly liquid strategies and products, often in the form of Alternative UCITS. We appreciate the correlation benefits of a steady, uncorrelated return stream provided with a decent Sharpe Ratio.

Asset Allocation

We run a large allocation to equities, and we underweight bonds, certainly by historical standards. Our commodity allocation is at the high end of our range. We aim to achieve a diversified portfolio with a proper risk budget for actively managed alternative strategies.

2021 is the year when the world starts to return to 'normal,' albeit under a new paradigm. Position accordingly.

Roland Eberhard
January 1, 2021

[i] For details please refer to https://ec.europa.eu/info/strategy/recovery-plan-europe_en

[ii] Suppose you have the capacity and interest to read one more article about Covid-19. In that case, I highly recommend Mark Honigsbaum's article "Challenging the 'Great Reset' theory of pandemics," published on Engelsberg Ideas on December 10, 2020 (3'000 words).

As allocators and investors alike, our role is to look ahead and position ourselves where the puck will be (and not where it is, using Wayne Gretzky's wisdom). We need to discount the causes and effects of the pandemic of 2020 in terms of capital allocation. Historians will see Covid-19, and the political and monetary reactions to it, as the trigger of a profound long-term change. The author puts last year's events into a commendable historical context. The essay sheds historical light on current coronavirus conspiracy theories, and as Mark Honigsbaum concludes, "we are inclined to view pandemics and other crises as moral and political turning points." As he puts it, Covid-19 could be the "resolution of long-standing social and economic grievances."

link: https://engelsbergideas.com/essays/challenging-the-great-reset-theory-of-pandemics/

[iii] For a fun read enjoy 'Saxo Bank 2021 Outrageous Predictions: The Future is Now', published December 8, 2020 at:

https://www.home.saxo/campaigns/pr/2020-h2/saxo-bank-2021-outrageous-predictions-the-future-is-now

Saxo Bank's predictions focus on a series of unlikely but underappreciated events which, if they were to occur, could send shockwaves across financial markets:

1. Amazon "buys" Cyprus
2. Germany bails out France
3. Blockchain tech kills fake news
4. China's new digital currency inspires tectonic shift in capital flows
5. Revolutionary fusion design catapults humanity into energy abundance
6. Universal basic income decimates big cities
7. Disruption dividend creates Citizens Technology Fund
8. A successful Covid-19 vaccine kills companies
9. Sun shines on silver, which sizzles on solar panel demand
10. Next-generation tech supercharges frontier and emerging markets

[iv] The median dividend yield is 4.3%. We run 24 positions, fairly equally distributed. Dividend yields per position range from a minimum of 2.9% to a maximum of 11.3%.

[v] Markets need to yet be given time to react to the news. The implications are profound though. For more background, see this well written article from a political angle: https://www.politico.eu/article/eu-china-investment-deal-angela-merkel-pushes-finish-line-despite-criticism/
And here an English version from China's perspective: https://www.scmp.com/news/china/diplomacy/article/3115588/all-eu-member-states-back-china-investment-deal-sources-say

[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."