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Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News
Financial markets decoupled from the real world by appreciating strongly in the context of a continued economic deceleration. Either the global economy will rebound as priced in or we experience a major price correction at some point. Markets will converge at some moment. But when and how?

Geopolitical and macro uncertainties create opportunities for agile speculators investing long and short. This is a time to add active strategies with uncorrelated returns and convexity.

One such strategy is merger arbitrage where M&A deal activity remains elevated due to high corporate cash holdings and cheap financing. Fixed income and vol arb profit from benign volatility levels in bond markets and asymmetry of returns.

A macro trade example would be to short Hong Kong property or the Hang Seng Index. Property has become too expensive for the young, they face a weakening Chinese economy and the Hong Kong $ peg leads to adjustments via asset prices.[i]

Economies & Monetary Policies
The global growth outlook is uncertain and weak. Globally, low interest rates are a symptom of deep structural issues with accommodative monetary policy being a necessary condition for sustaining the upturn. The Fed is being expected to keep rates low until the election, which is still 15 months away.

Once the markets perceive central banks as being done with easing the QE trade will unwind. A clear sign is that corporate bond spreads have widened despite sovereign bond yields dropping.

The current situation for sovereigns was compared to Prince Rupert's Drop[ii] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[iii]

Politics
Brexit: A no-deal withdrawal on October 31 promoted by the newly appointed Prime Minister Johnson could see GBP/USD fall below the historic low reached in 1985. Under this scenario we would expect a rate cut by the Bank of England to ease financial conditions amidst the inevitable slowdown.

The White House treats tariffs and sanctions as key policy tools. At least, the US President seeks re-election for which he needs a higher stock market and a growing GDP.

Equities
US equity indices have reached new all-time highs. The MSCI World is not much below the high reached in January 2018. The S&P 500 surpassed 3000 for the first time ever. Asian shares ended the month at roughly 6-week lows on trade worries. Bulls would point out that the S&P 500 forward P/E ratio is only slightly above the average of the 1990's.[iv]

As software applications proliferate, the complexity of collecting and organizing enterprise data has only increased. This is a sub-sector in tech with strong growth potential.

Fixed Income & Credit
Among Western sovereigns only the US returns a positive yield for the entire curve. The entire Swiss yield curve is negative, the only country in the world with such a distinction. For German debt, all but the 30-year are negative.

Another way to look at the entire universe of negative yielding debt is by maturity. 18 countries have a 1-year debt trading at yields below zero.

USD bulls vs. bears: The positive interest rate differential between the USD and the other currencies pushes the USD higher, or at least prevents it from falling.

Emerging Markets Currencies & Debt
Big beneficiaries of the monetary-policy turn are the more fragile EM economies. The rate differential between DM and EM point to potentially sustained capital flows into EM countries that are pursuing integrationist policies.

Another beneficiary of the turn in monetary policy are big debtors who are dealing head-on with their debt loads. The low rates make the cost of refinancing notably lower, their relatively high-yield status more of a draw to investors, and so their heavy debt loads become more sustainable. Indeed, one underlying objective of the low-rate policy is to enable debt-stocks to be digested and grown out of. Buying long-dated bonds that have significant credit spreads of debtors typically offers good rewards in such easy-money times.

Commodities
Gold trades at a 6-year high. The gold/silver ratio is at a 25-year high. US led trade wars create uncertainty, a positive for gold, but weighs on silver.[v] Supply of physical gold is tight, leading to a gap risk of higher prices. We remain bullish gold.

Asset Allocation
In conclusion, we are a lot less optimistic but not bearish.

Overweight equities vs. fixed income. Stick to liquid asset classes to stay flexible and nimble without opportunity costs since the premium for lack of liquidity has been eroded anyway.

We are amidst a megatrend of technological disruption. As the world goes digital overweight the disrupters. In sector allocation consider healthcare, biotech and technology.

Roland Eberhard
August 1, 2019[vi]

[i] The trade war has real consequences. Take this news story dated July 3, 2019 from Reuters: "Several technology companies, including HP Inc HPQ.N, Dell Technologies DELL.N and Microsoft Corp MSFT.O, are planning to shift substantial production capacity out of China, Nikkei reported on Wednesday, citing sources.

HP and Dell are planning to reallocate up to 30% of their notebook production out of China, Nikkei said.

Microsoft, Google, Amazon.com Inc AMZN.O, Sony Corp 6758.T and Nintendo Co Ltd 7974.T are also looking at moving some of their game console and smart speaker manufacturing out of the country, Nikkei added."

[ii] Equinox Partners

[iii] 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."

[iv] The S&P 500 P/E Ratio Forward Estimate is about 17.9 now vs. 15.4 then. The actual P/E is 20.73 as of yesterday's close.

[v] Roughly, industrial use for silver is 60% of annual demand while industrial use for gold is 10% of annual demand.