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The Swiss Merchant Bank

# Baer Necessities

## January 2020

## Perspectives for Strategic Asset Allocation

**Observations, Markets & News**

The broad commodity index[i] now offers a positive roll return. US policy makers, political and monetary, are determined to cause rising inflation. If, or when, they succeed shareholders should buckle up as equity divergence will increase; one should then short USD vs. EUR since it is a lot harder to create inflation in the Eurozone. Long gold and long commodities, both traded in USD, would be winning trades, too.

If they don't succeed, expect more QE type measures, and perhaps a new US president, too. A lot is at stake.

**Economies & Monetary Policies**

Synchronous asset purchases in the US and in the Eurozone are positive and will last until spring for all one knows.

**Politics**

Political risks have abated. The trade deal could boost capital investment and trade leading to higher commodity prices.

**Equities**

Coordinated monetary and fiscal easing in all big economic blocs means a broad rally is sustainable. Whether the US can go on outperforming depends partly on the USD's direction.

For those questioning our positive outlook consider that the equity risk premium is currently at 6-7% (but was at -3% in 2000).[ii] Bull markets die mainly from a euphoria that is nowhere to be seen. Fiscal policy being debated everywhere has profound ramifications rendering recessions in 2020 unlikely.

Themes and sectors we like include Ageing Population, Digital or Cyber Security, Digitization, Automation & Robotics, Artificial Intelligence & Big Data, Water, and Biotechnology. Sectors with a wider dispersion require active managers though.

**Fixed Income & Credit**

Underweight: Markets are stretched but we have not yet arrived at the nadir in rates. Tight valuation limits the potential for outperformance. Bonds no longer diversify stocks with yields and spreads as low as they are. Duration risk is high.

We keep a positive view on the GBP following the UK election. Pound denominated corporate bonds offer upside, too.

High yield bond managers report that in several cases the market is struggling to price default probability and/or worst-case recovery potential properly.

Yields on so many sovereign bonds do not reflect their inherent risks.[iii] The current situation for sovereigns was compared to Prince Rupert's Drop[iv] ("larme de verre"), in that what is perceived as a strong, balanced system one day could blow up the next.[v]

**Emerging Markets: Equities, Currencies & Debt**

We expect attractive returns from Emerging Market (EM) equities, performing in line with global equities. The earnings momentum has picked up and valuations of EM equities compared to global equities are reasonable. EM are anything but a homogenous bloc: Brazil and China look attractive while other LatAm markets or South Africa do not.

Local currency bonds could be alluring, particularly in Eastern Europe, Middle East and some African countries. Argentina looks enticing. The US-China trade deal will favor Asian currencies and local currency bonds.

**Commodities**

Relative to each other equities are expensive and commodities are cheap. The ratio of the S&P GSCI vs. the S&P 500 is now about as low as it was in 1972 (!): Commodities are over-sold and under-allocated. Commodities tend to rise in the later stages of the economic cycle. So far this has not been the case. They always swing back, often in sharp moves. Given the positive roll yield the downside risk seems limited. Commodities complement a portfolio as a hedge against rising inflation or supply interruptions due to the trade war.

Precious Metals also remain a complementary asset class to equities. The small negative carry from holding physical gold is still better than the negative sovereign yields.

We remain bullish on Precious Metals because of an overall supply/demand imbalance.[vi]

**Asset Allocation**

Humans tend to extrapolate recent events, and as investors we tend to overstay our welcome. If we just look back, we can't see what's coming. Just as 2019 turned out a whole lot different than 2018 so will 2020. This year will provide opportunities and risks divergent and new.

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 in public markets.

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

Consider adding tail hedges. Alternatively, add active strategies with uncorrelated returns and convexity.

Keep your equities, increase precious metals, and consider adding commodities during Q1 2020. Happy New Year!

Roland Eberhard

January 2, 2020[vii]

[i] S&P Goldman Sachs Commodity Index (S&P GSCI)
The forward curve of Brent and WTI is in backwardation due to supply cuts. Crude production growth has weakened and prices will need to go higher for it to revive. Given OPEC's ongoing cuts, strength for Brent is likely to remain.
Incredible anecdote: In the first week of December, for the first time ever, the market cap of Apple surpassed that of the entire S&P 500 Energy Index, which includes America's 28 largest energy firms such as Exxon Mobil and Chevron. Interestingly, both Apple and the S&P 500 Energy Index (i.e., the combined 28 companies) generated roughly $58 billion in cash flows (after operating costs) over the last 12 months, which is a 4.8% free cash flow yield. By this comparison, the similar valuations make sense.
While we do believe that renewable energy, electric vehicles and synthetic plastics will curtail conventional energy demand growth in the coming decades, eventually leading to a prolonged decline, it is unlikely that oil and gas are anywhere close to disappearing. For the contrarian investor, we think it is perhaps a signal to consider a moderate investment in an economically vital sector.
(Source: Morgan Stanley and proprietary research)

[ii] All forecasts will be wrong to some degree by definition. Still, projections by The Capital Spectator tend to be roughly correct, which are as follows for 2020: 6.2% US Stocks; 7.2% Non-US DM Stocks; 8.3% EM Stocks; see also https://seekingalpha.com/article/4310422-risk-premia-forecasts-major-asset-classes-3-december-2019
or http://www.capitalspectator.com/

[iii] Bloomberg published a thought-provoking article on November 13, 2019 (Brandon Kochkodin, Bloomberg, 'LTCM Co-Founder Finds Infinite Value in Bonds on Negative Rates'). Quote: "Perhaps more realistically, consider Austria's 100-year bond, one of the closest approximations to a modern-day sovereign perpetual bond out there.

The same bond-pricing calculator produces a price of 173 euros when you use its current yield of 0.95% as the discount rate, an indication the market expects interest rates to average about 1% over the remaining 98 or so years of the bond's life.

But assume the discount rate falls to -0.5% and then stays there, then the bond's expected price shoots past 400 euros."

[iv] Equinox Partners

[v] 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."

[vi] Gold could be the harbinger of bad news in the sovereign debt markets. See comments by the Dutch Central Bank, known as De Nederlandsche Bank (DNB), which wrote on October 15, 2019 that gold would be indispensable in the event of a fiat meltdown. (!) The Central Bank wrote: "Gold is the perfect piggy bank – it's the anchor of trust for the financial system. If the system collapses, the gold stock can serve as a basis to build it up again. Gold bolsters confidence in the stability of the central bank's balance sheet and creates a sense of security."

see also:

https://www.dnb.nl/en/payments/goud/index.jsp#

https://www.dnb.nl/en/news/dnb-publications/financial-stability-report/dnb385947.jsp

https://www.dnb.nl/en/news/news-and-archive/Nieuws2019/dnb385962.jsp