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The Swiss Merchant Bank

Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News
Software is eating the world: The FAATMAN stocks have added roughly $1.75 trillion to their capitalization this year so far.[i, ii] None of the FAATMAN group are pure software companies, but technologically they are all at the forefront of their respective industries. Any doubts? - Read Jeff Bezos' ingenious Congressional testimony.[iii]

Two major contributors to this bull market are passive investing via Exchange Traded Funds (ETF's) and algos. Liquidity is actually worsening even though market capitalizations are increasing because the share of discretionary management is decreasing. The bigger the market capitalization of a company, the higher its weighting in the index, the more passive investment dollars it attracts, the more shares need to be found, and the more discretionary managers underperform as fundamentals become their biggest enemy.[iv]

Once the spiral turns it could lead to a historic equity crash. When passive investment programs start to face redemptions there might not be enough sellers left leading to plunging equity prices. The first crash driven by algos was on Black Monday in October 1987 when the Dow Jones dropped by -22.6% in a single day. The risks are rising for something similar to occur.

Politics, Economies & Monetary Policies
EU Exceptionalism: We are confident in the positive developments in Europe and the upcoming implementation of the EU Recovery Fund. This is a major boon for European financial markets.

The long-term precedent it establishes is a quasi de facto fiscal union framework. It gives the EU the tools to better cope with future economic challenges while fostering convergence between EU members. It could rotate capital flows towards Europe leading to outperformance of European assets.

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").[v]

Equities
If you divide the S&P500 into the S&P10 and the S&P490 you find that this year's return of the overall index has come from the ten largest companies alone.[vi] As a group, they are up 35% YTD while the other 490 stocks are down more than -10% YTD.

China A shares continue their rally. Mainland China retail investors are the main driver. The expanding index inclusion of China A shares is a tailwind for the next three to four years. A combination of factors such as expectations of ongoing policy support, a raft of heavily over-subscribed mutual fund launches, and Chinese media commenting on a prolonged bull market, give the impression of a strong put.

Margin financing of about 18% of total China A share market turnover in 2015 led to the correction of close to -50%. The current number is around 13%.[vii] In 2020, the market framework is structurally different. What remains the same is a high dispersion between sectors.

Fixed Income & Credit
The USD is in danger of losing its world's reserve currency status.[viii] The rapid acceleration of renminbi internationalization is a major challenge to the USD dominance, particularly with the launch of the e-RMB, a digital currency partly backed by gold.

We have added Chinese sovereign and corporate debt in spring. Our thesis remains intact.

Commodities
As gold breaks out to reach new highs we remain bullish but do become more cautious. 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
Buy an umbrella on a sunny day: What we have seen since the 2008 financial crisis is a fragile system that, from time to time, has to be rescued by central banks and national treasuries, especially in the developed countries.

The current market equilibrium looks stable until it is no more. 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
August 3, 2020[ix]

[i] The FAATMAN stocks are Facebook, Alphabet, Amazon, Tesla, Microsoft, Apple and Netflix: Collectively, these seven stocks have gained over $1.75 trillion of value so far this year.

[ii] Software Is Eating the World, Marc Andreessen, originally published in The Wall Street Journal on August 20, 2011. Available at the author's corporate website:
https://a16z.com/2011/08/20/why-software-is-eating-the-world/

If you have not yet read this essay do so now. It's a timeless description of the ongoing technological revolution of our age.

[iii] Statement to the House Judiciary Committee, Jeff Bezos (Amazon), July 28, 2020: https://blog.aboutamazon.com/policy/statement-by-jeff-bezos-to-the-u-s-house-committee-on-the-judiciary
Bezos' Congressional testimony is a marvel of storytelling, which should be taught in business schools and law schools for decades to come as a defense of 21st-century capitalism in general, and of big tech in particular. "Just like the world needs small companies, it also needs large ones. There are things small companies simply can't do. I don't care how good an entrepreneur you are, you're not going to build a Boeing 787 in your garage." As referenced by www.TheBrowser.com.

[iv] The regime change is well documented by Two Sigma in a white paper published on July 27, 2020. They conclude that the book-to-price ratio seems to have become less effective over the years at identifying value stocks, perhaps because the accounting book value does not take into account intangibles that have become a significant contributor to firms' profitability and operating efficiency, and, hence, their fundamental value, in the new economy. They conclude that "no such regime change is observed for a value strategy based on earnings yield—a value measure that accounts for the economic gains from intangibles."
Diagnosing the Recent Decade of Drawdown in Value, Pushkar Agrawal and Mike Nigro on July 27, 2020

Free download:
https://www.twosigma.com/insights/article/diagnosing-the-recent-decade-of-drawdown-in-value/?_42242

[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] The ten largest market caps in the index are Microsoft, Apple, Amazon, Google, Facebook, Visa, Mastercard, Nvidia, Netflix and Adobe.

[vii] Source: Refinitiv DataStream, Allianz Global Investors, as of July 14, 2020

[viii] Goldman Sachs warned as such last week: Goldman Warns the Dollar's Grip on Global Markets Might Be Over, John Ainger and Liz McCormick, Bloomberg, July 28, 2020:
https://www.bloomberg.com/news/articles/2020-07-28/goldman-warns-dollar-s-role-as-world-reserve-currency-is-at-risk?