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Baer Necessities

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Perspectives for Strategic Asset Allocation

Observations, Markets & News

Zip it for ZIRP: Zero Interest Rate Policy[i] is here to stay, no matter what. Not that long ago we discussed with clients how long it would take to double one's wealth. Divide 72 by the rate of return to receive the number of years it takes.[ii] Bonds doubled in 14 ½ years at a 5% yield. An equity portfolio doubled every eight to ten years with an average return of 7% to 9%.

With ZIRP a certainty for the foreseeable future there are only two asset classes that have the potential to double. One is working capital in the form of equities, publicly listed or private. The other is the commodity sector, which is speculative and would pay off particularly well if inflation was to rise.

Politics, Economies & Monetary Policies

America is divided, looking increasingly at war with itself. Biden is likely to win the popular vote like Hillary Clinton and Al Gore, but neither of whom became President. The fight for the majority of the electoral college looks too close to call. "Swing states" will make all the difference.[iii] The probability is high for a disputed election that is decided in state capitols or by the Supreme Court. Moreover, a split Congress looks like a decidedly probable scenario.

In China the rebound is on its way: Export numbers surpassed all expectations for August with a YoY gain of 9.5%. Exports rose most in 18 months as economies reopen worldwide.

US' containment policies seek to isolate, contain, diminish and internally divide China plus to sabotage her leadership in overt and covert tactics. This policy has started during President Obama's 1st term. The rhetoric has changed under Trump but the long-term policy remains in line enjoying bipartisan support.

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]

Jamaica's Central Bank released a Reggae tune with the theme of inflation stability featuring artist Denyque with the lyrics, "We don't want you too high, we don't want you too low, when inflation's stable and predictable, that's the way to go."[v]

An asset rises in price if there is a demand overhang, i.e. if the demand is higher than its supply. This can be for two distinct reasons, either the asset is scarce or it enhances economic efficiency. An example of the first is gold where the production is restricted by the capital constraints of gold miners and of the second is tech. We like both, not least for diversification reasons.

Equities

Monetary policy remains hyper-supportive for equities. Shareholders have a stake in companies that profit from super low interest rates, lose fiscal policy and occasionally, such as in Europe starting in January, from direct investments from government or government like entities. Hence, long-term asset allocation should overweigh equities and underweigh fixed income. Also, include alternatives with a long vol bias.

It is possible that Chinese equities will remain uncorrelated to other major equity markets.

Fixed Income & Credit

Globalization is being questioned, policies are being reversed. Free movement of labor is being challenged. Government spending has risen, dramatically even in some countries like the US. Rising tariffs are an inflationary policy. The Fed intervening directly in bond markets reduces the private sector's ability to price capital and risk.

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%. Plus, the yuan is a strong currency.

Commodities

Gold tends to outperform cash when monetary policy is lose. Historically, gold has done well when policymakers are devaluing fiat currencies through money printing. September looks like a technical correction in a long-term trend upwards.

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 financial markets.

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
October 1, 2020[vi]

[i] The new framework for US monetary policy announced at the Jackson Hole symposium in August is a milestone. It places maximum employment first among the Fed's objectives, and abandons any mention of a "balanced" approach to policy.
The full statement is worth reading. To be crystal clear about their intention to target "maximum level of employment" first and to let inflation potentially rise above the previous 2% target the Fed's website highlights the changes in policy:
https://www.federalreserve.gov/monetarypolicy/guide-to-changes-in-statement-on-longer-run-goals-monetary-policy-strategy.htm

[ii] This is referred to as 'The Rule of 72': The rule states that the number of years it takes to double an investment is estimated by dividing 72 by the rate of return.
For example: A rate of return of 7% takes a good 10 years (72 : 7 = 10.3); a rate of return of 10% takes a good 7 years (72 : 10 : 7.2).
A rate of 1% takes 72 years. A rate of 0.5% takes 144 years. Since most bond yields are below 0.5% it is merely impossible to grow one's wealth significantly over any period.

[iii] The typical "swing states" are Arizona, Florida, Michigan, North Carolina, Ohio, Pennsylvania and Wisconsin.

[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] https://twitter.com/i/status/1299127633364557826 / https://www.youtube.com/watch?v=RuAwYsbUq48