ASSET ALLOCATION PERSPECTIVES

CIO Office

ASSET ALLOCATION AND FINANCIAL REPRESSION

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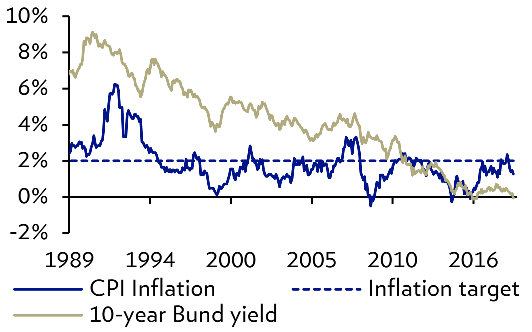
Protecting your capital against the certainty of a loss

FORWARD LOOKING PERSPECTIVE

Most asset allocation studies draw conclusions based on asset class returns and correlations prevalent in the last 40 years. However, investors today are confronted with a very different set of circumstances as compared with the early 1980's, when Paul Volcker was appointed Chairman of the US Federal Reserve, steering monetary policy to control inflation and ultimately leading the way to CPI targeting, the commonly accepted philosophy in world-leading central banks up until the great financial crisis of 2008. Back then, interest rates on 10-year US Treasuries were at 15%. At the wake of German reunification, when the Berlin wall fell in 1990, 10-year German Bund yields shot up to more than 9%. Today, the same German Bunds, converted from Deutsche marks to euros, yield a slightly negative - 0.1%. Core inflation in Germany averaged +1.5% over the 12 months at end April 2019. Inflation linked 10-year German Bund yield -1.27%. Real rates have been negative for several years now and the European Central bank has consistently undershot its stated inflation objective of close to 2%.

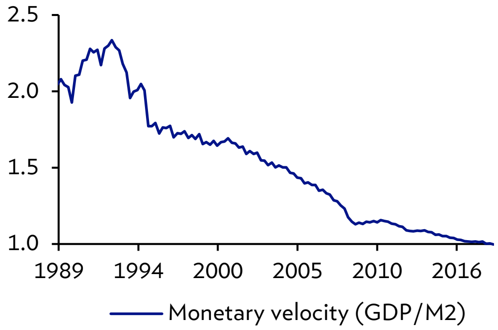
CHART 1 – GERMAN 10-YEAR BUND YIELD AND CPI INFLATION



Source: OECD, Bloomberg, Julius Baer

This state of affairs is not entirely accidental. We describe in our annual update of the Julius Baer Secular Outlook several structural trends. In Europe, the macroeconomic policy mix of extreme monetary stimulus coupled with fiscal restraint is the exact opposite of what the current economic situation of the Old Continent would require. The issue is very well explained by Dr Richard Koo in his book 'The Other Half of Macroeconomics and The Fate of Globalization'. Most politicians and policymakers apply economic principles drawn from the lessons learned during the inflationary period of 1965 through 1985. CPI targeting was born out of this inflationary era during which Southern European countries were relentlessly devaluing their currencies and funding public deficits through a technology called the printing press. The Maastricht criteria were set up in order to prevent such policies in the wake of the euro's launch. Unfortunately, the circumstances after three decades of globalisation and financialisation could not be more different. Confronted with pedestrian GDP growth and anemic inflation, as well as with soaring public debt of the on- and off- balance sheet kinds, governments have resorted to financial repression.

CHART 2 – MONETARY VELOCITY IN THE EUROZONE



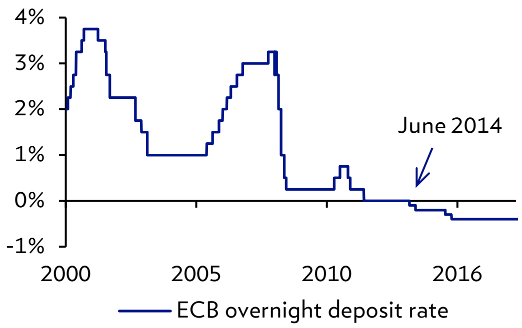
Source: Bloomberg, Julius Baer

THE ERA OF FINANCIAL REPRESSION

Financial repression describes a variety of policies and means through which governments transfer wealth from the private sector to the public sector. More specifically, financial repression targets household wealth, as corporate wealth is agile and mobile in a globalised world. Negative interest rates serve that exact and precise purpose of confiscating private capital and transferring it to the government. Investors are confronted with the certainty of a loss when investing in the risk-free asset, in particular once inflation is accounted for. Meanwhile, taxes are still due on top. Such transfers of wealth might seem negligible over the short-term, but the cumulative impact over one decade or more is devastating.

Financial repression started a few years ago in Europe. The ECB has recently committed to keep rates unchanged (negative) well into 2020. Even if rates were at some point normalised back to a slightly positive territory, real rates, and most critically the after-tax real rate of return on low risk euro assets, will remain negative for years to come. As long as the mix between fiscal and monetary policy is not radically recalibrated, the secular trajectory of the euro area economy will progress in a slow motion 'Japanification'. At some point, Europe might change its policy mix, but this is a very long-term prospect given the nature of the Continent's political decision-making system involving 28 countries. The question therefore is what one should do to protect himself against confiscation and the certainty of a loss under financial repression.

CHART 3 – ECB POLICY RATE

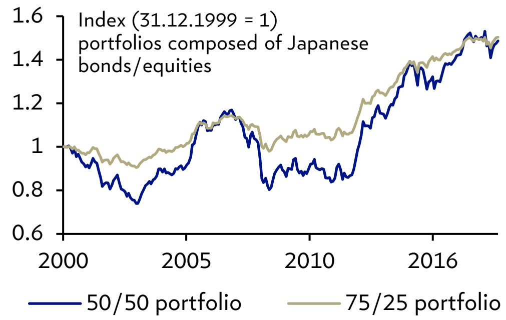


Source: Bloomberg, Julius Baer

LESSONS FROM JAPAN

Luckily, Japan, who has experienced a balance sheet recession since the mid 1990's and zero to negative interest rates for 20 years, can provide us with some interesting insights into the consequences of financial repression on a typical investment portfolio combining nominal and real claims, domestic bonds and domestic equities. Such a portfolio carries no currency risk, removing the additional issue of currency-induced drawdowns in the strategy. Chart 4 shows the cumulative return of a 75/25 (bonds/equities) and a 50/50 portfolio of Japanese bonds and equities since 2000, and Chart 5 shows the 5-year rolling returns of these strategies.

CHART 4 – CUMULATIVE RETURN INDEX OF JAPANESE MULTI-ASSET PORTFOLIOS

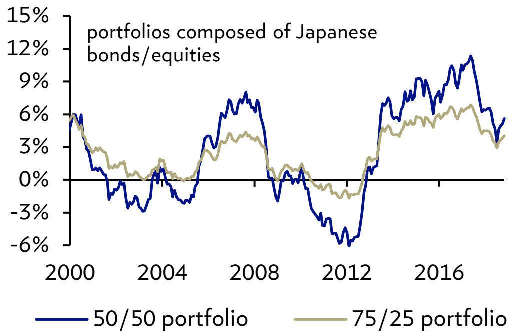


Note: FTSE Japanese government bond index and MSCI Japan; returns are **gross of fees**
Source: Bloomberg, Julius Baer

From January 2000 to April 2019, both the 50/50 and the 75/50 versions of this simple strategy returned 2.1% on an annualised basis. The analysis of Chart 5 provides some interesting observations:

- Even during the worst 5-year rolling window (June 2012), a Japanese 75/25 portfolio has not performed much worse than cash, yielding zero to negative returns
- During the most favourable 5-year rolling window (November 2017), this same 75/25 portfolio has produced a + 6.9% annualized return

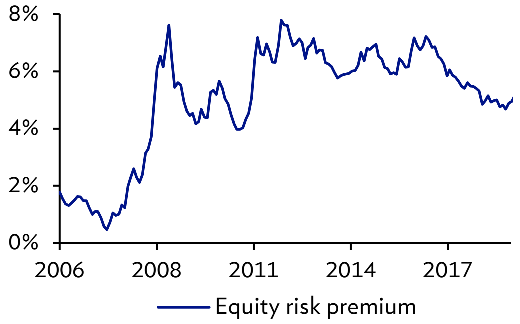
CHART 5 – 5-YEAR ANNUALISED ROLLING RETURNS OF JAPANESE MULTI-ASSET PORTFOLIOS



Note: FTSE Japanese government bond index and MSCI Japan; returns are **gross of fees**
Source: Bloomberg, Julius Baer

The comparison is not only relevant because of the similarities with the euro area and the length and of the observation period, but also because Japanese equities are a conservative benchmark given the structural misallocation of retained earnings in corporate Japan (CIO Flash April 2019 'Reflections on portfolio construction and the case of Japanese equities'). Going forward, we actually expect Eurozone equities to produce better returns for shareholders compared to their Japanese peers' historical performance, as capital allocation is much better in Europe than in Japan. Our estimated prospective risk premium for European equities actually stands at more than 5% over euro cash.

CHART 6 – EUROZONE EQUITIES EX ANTE EQUITY RISK PREMIUM



Source: Bloomberg, Julius Baer

In conclusion, euro-based wealth owners are confronted with a choice between the certainty of a net loss on cash deposits after inflation and taxes and the high probability of a gain over a period of a few years using a prudent mix of euro credit and equities. We recommend to:

- Prepare for lasting financial repression
- Increase your investment horizon
- Focus on income generation, minimising negative yielding assets after inflation, and clipping coupons
- Add REITs to your portfolio for income generation
- Ignore short-term portfolio fluctuations induced by mark to market volatility and political noise

The cost of a good night's sleep over the short-term is very expensive in the medium-term

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THE JULIUS BAER ASSET ALLOCATION APPROACH

INVESTMENT BELIEFS

FUNDAMENTAL ISSUES

- There are a few absolute investment truths
- There must be a set of investment beliefs that reflect our strengths and weaknesses as investors

INVESTMENT HORIZON

- The investment horizon is a crucial factor for determining the appropriate investment strategy
- **Short investment horizons and excessive risk aversion lead to unnecessarily high costs of protecting the downside**
- We encourage our clients to consider lengthening their horizon and to face their investment biases just as we fight our own

MARKET BEHAVIOUR

- Mean reversion may not happen within a useful time frame
- Our Secular Outlook provides valuable guidance

SKILL, EDGE AND MARKET EFFCIENCY

- There are few arbitrage opportunities
- Noise is not information: active bets must reflect a testable edger and be original (differ from consensus)
- Contrarian views are to be used sparingly

STRATEGIC CHOICES

- **Most of the time it pays to be fully invested**
- The chosen strategic asset allocation must be survivable
- Market timing by committee adds no value – a single risk taker might
- **Portfolio construction is central: combining building blocks into a meaningful portfolio**

SECULAR OUTLOOK 2019-2023

MACROECONOMY

- End of the post-Cold War neoliberal consensus
- Monetary normalisation
- Accelerating digital disruptions
- Emerging market debt cycle still ahead
- Post-Merkel Europe

CAPITAL MARKETS

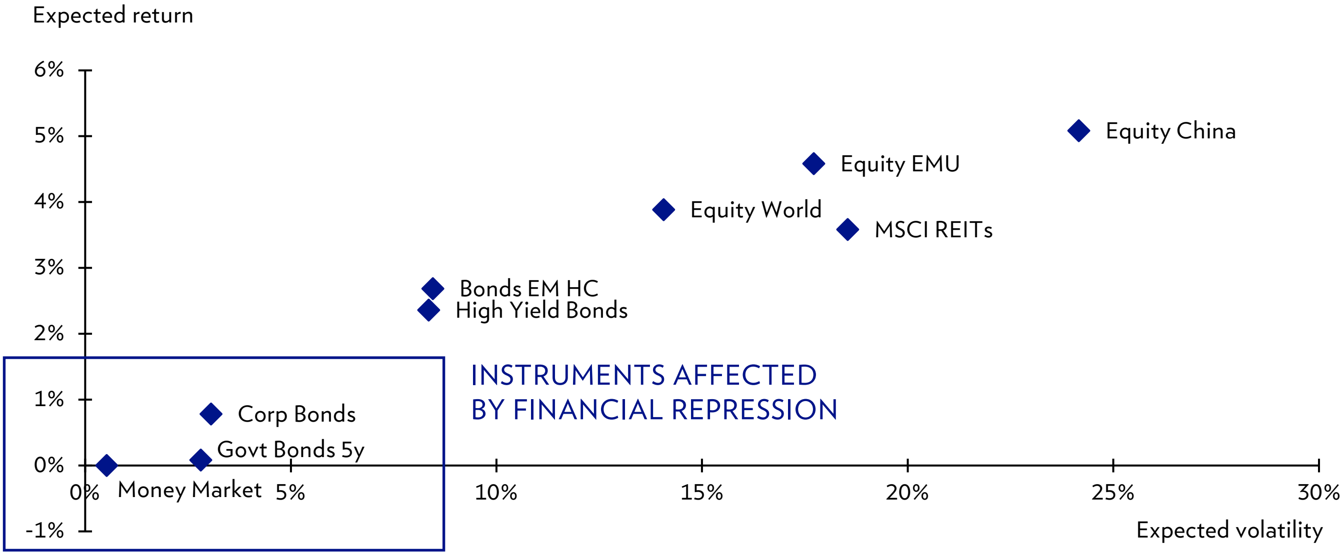
- Blurring borders between public and private markets
- Rise of political triggers and decline of market signals
- Long-term rates bottoming out
- US dollar secular bull trend challenged
- Convergence of the world's biggest growth engines: emerging economies and technology
- China rising to core asset class status

RISK FACTORS

- Peak asset valuations
- Dormant systemic risk
- Rise in cyber risk
- Global political risk
- China

CAPITAL MARKET ASSUMPTIONS

10-YEAR EXPECTED RETURNS AND VOLATILITY FOR EUR ASSETS



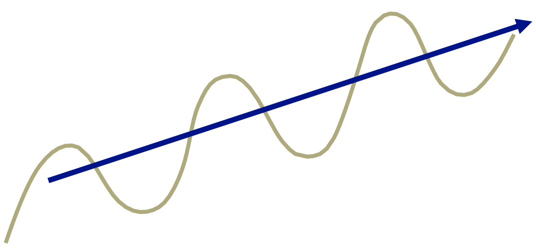
Source: Julius Baer, data as at 31.05.2019

THE FOUR INVESTMENT REGIMES

We assess markets and act tactically based on four predefined investment regimes, introduced in 2016.

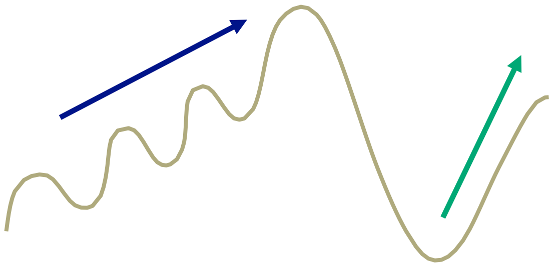
TYPICAL MARKET BEHAVIOUR

Sentiment drives ups and downs



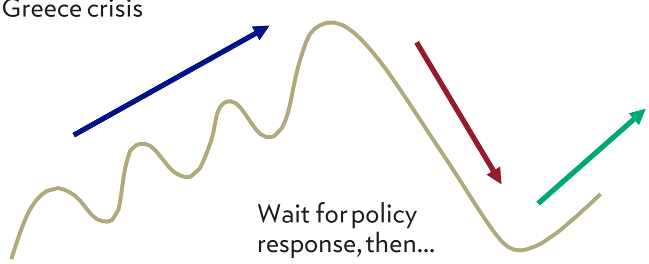
EXTERNAL SHOCK

Market reaction following an external shock e.g. 9/11



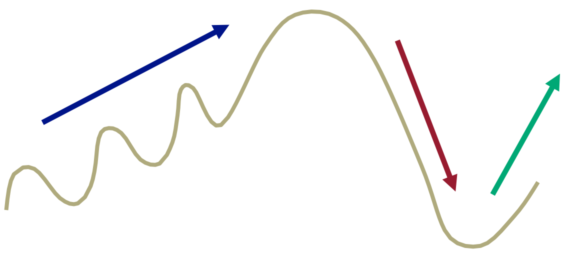
SYSTEMIC ISSUE

Market reaction in times of systemic issues e.g. Greece crisis



ECONOMIC CONTRACTION

Market reaction in times of economic contraction



STRATEGIC ASSET ALLOCATION (SAA) 2019

RISK PROFILE	**INCOME**	**BALANCED**	**GROWTH**
MONEY MARKET	**5%**	**5%**	**5%**
FIXED INCOME	**60%**	**40%**	**20%**
Government	26%	15%	5%
IG Corporates	26%	15%	5%
High Yield Hedged	5%	5%	5%
Emerging Markets HC Hedged	3%	5%	5%
EQUITIES	**30%**	**50%**	**70%**
Home Bias	9%	15%	21%
World Equity	15%	25%	35%
China	3%	5%	7%
Domestic REITs	3%	5%	7%
AI	**5%**	**5%**	**5%**
FX (OWN CURRENCY EXPOSURE)			
EUR	84%	73%	62%
CHF	82%	71%	59%
USD	91%	86%	80%

HIGHLIGHTS SAA 2019

Now use a quarterly re-balancing frequency

Unhedged world equities and dropped the FX over-lay

Same proportions for all equity sub-asset classes

Balanced and Growth profiles now available with Private Equity

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