BFI INFINITY

CEO Corner

The year ahead: Expect the best, prepare for the worst

Daniel Zurbruegg
CEO BFI Infinity

The past year was exceptional from an investing point of view. After a very difficult fourth quarter in 2018, with heavy losses in global equity markets, the rebound that started early in 2019 lasted much longer than many expected. In fact, despite the recent volatility caused by increasing fears of the coronavirus spread and the political tensions between the U.S. and Iran over the killing of Qassem Suleimani, the bull run in global equities might have further to go, even though most likely the coming weeks will be challenging.

For many, 2019 began with the assumption that central banks would try to normalize monetary policies by hiking interest rates a number of times. This was particularly true for the Federal Reserve, which at the time, had clearly signaled its intentions to turn to a tighter policy direction. However, it quickly became obvious that this would not happen, especially as the trade tensions between the U.S. and China and the increasing tariffs implemented by both sides created a challenging economic climate. It did not take very long until the outlook for global growth became more pessimistic and growth estimates were repeatedly revised downwards.

Central banks responded with more liquidity and lower rates, once again fostering a very positive environment for global stocks. As a result, investors continued to bid up stock market prices, despite very slow earnings growth. Higher equity prices and flat earnings growth meant that valuation multiples increased further during 2019 and led to the premium of the U.S. stock market recently hitting an all-time high. So, either U.S. stocks are far better in terms of future earnings growth or they are way overpriced, compared to international markets. Our own view on this is very clear: we think non-U.S. equity markets are trading at compelling long-term valuations, especially considering the long-term outlook for the U.S. Dollar, which does not look good at all. In hindsight, we were probably a bit too conservative with our equity investments, as we have been holding hedges against our equity positions throughout the second half of the year. Nevertheless, we still feel that ensuring downside protection was absolutely the right decision at the time and we regard the hedge premium as an insurance cost in a rather challenging environment.

What was exceptional last year was that most other investments were also doing well, with pretty much every asset class showing positive performance. Bonds obviously had a great run, as the Fed started to reverse its course and bond yields around the globe began to fall and bond prices shot up. Despite the fact that most of our bond holdings are by high quality issuers, we experienced compelling returns without really taking on a lot of credit risk in our position.

The market environment last year was also supportive for precious metals, which typically have a strong allocation in our portfolios. Our readers will remember that about a year ago, we were already starting to adopt a more optimistic outlook on precious metals and indeed, the policy reversal of central banks in the second half of the year did provide a very supportive environment for these assets. Of course, some investors feel that gold should have done much better given this sharp monetary policy U-turn, but we mostly still see gold as a hedge against more systemic problems and crises. This became obvious in early January, when the killing of Iranian general Qassem Suleimani stirred fears of a military escalation in the Middle East and when the coronavirus started to spread. These two events were enough to push gold prices towards the USD 1600/ounce level. Other investments, such as global real estate, also performed very well. Asian Speciality REITS had an especially strong year, with most of our investments in these REITS going up more than 25% and dividends in excess of 5%.

Somewhat surprising for us was the fact that the U.S. Dollar has been holding up really well, despite the sharp fall in yields. While we feel that the long-term prospects of the greenback continue to be rather challenging, in the short- to medium-term, it could continue to perform relatively well. For now, the factors that support the Dollar in the short-term still seem to be stronger than the long-term concerns. Nevertheless, the long-term case against the USD remains very strong and presents a good reason for investors to diversify internationally.

After a very strong 2019 and a rather volatile start to 2020, we had intense discussions at our latest quarterly investment committee meeting regarding the current market climate and the implications for our investment strategy. From a macro-economic point of view, we remain rather cautious. We think that the first half of 2020 could be disappointing and expect the negative economic trend to continue for the time being. This is somewhat contrarian to most views and expectations of a gradual improvement this year, following the long-awaited trade deal between the U.S. and China. However, the current economic expansion in the U.S. continues to be late-stage, meaning that after 10 years of growth, a slowdown, and maybe even a recession, is overdue. Thus, slowing growth, coupled with high valuations, make any market more vulnerable and increase the risk of an equity market correction. The main issue here, however, is that the current slowdown and low earnings growth are overlapping with monetary stimulus, which will probably be reinforced by fiscal stimulus soon too. This might prevent the market from correcting and even drive up prices even higher. It is therefore impossible to say at this point how big the risk for an equity market correction actually is.

Thus, we are convinced that in the short run investors need to hedge their bets, but still continue to be almost fully invested. This way, should the markets indeed suffer further losses, the impact on portfolios would be limited. However, if they continue to move higher in the first half of 2020 due to a continued reinflation of asset prices, the hedge premium would only have a small impact on the potential gains. This was the main conclusion from our quarterly investment committee meeting and the core idea behind our current strategy at BFI Infinity.

More specifically, while bonds globally offer very low yields, our overall exposure to fixed-income investments remains moderate. We increased the duration somewhat last year and we are currently not planning to change anything in our approach. We simply see no reason that would justify such a change. Interest rates around the world are low and will remain low for the time being, as consumer price increases are still also very weak and under control. Of course, that's a very different story from asset price inflation, which is obviously on the rise in equity markets, bonds and precious metals. While this development might be a serious long-term risk in itself, we expect it will take years of asset inflation before consumer prices follow suit. It will probably take a few more rounds of quantitative easing and fiscal stimulus from governments around the world.

This, however, is already happening. The Federal Reserve in the U.S. has started to increase the size of its balance sheet again since late 2019 and continues to do so. The Chinese Central bank has also announced new liquidity injections into the financial system to combat the negative effects of the coronavirus outbreak and its negative effects on the Chinese and the global economy. We expect central banks to continue to do what they have been doing for the past few years and that is to keep monetary policies very expansionary. Going forward, this will most likely be combined with stronger fiscal stimulus around the world. The U.S., Europe, the U.K. and China have all started different types of stimulus packages in order to avoid a recession at all costs. This means that the probability for a continued asset inflation remains very high and could in fact get even more extreme in the next year or two.

Our strategic view has also not changed when it comes to precious metals. There seems to be a bit of a risk premium built in the current price levels, so we can't rule out a short-term pullback. However, we remain optimistic for the rest of the year, as the above-mentioned expansionary policies from central banks and governments will continue to provide ample support for further price gains. We also continue to focus on certain areas within alternative investments that we think are offering compelling risk/return profiles. This includes hedge funds, especially strategies that are uncorrelated to equity markets, as well as special areas such as Asian REITs.

Our outlook for currencies hasn’t changed much since Q4 2019 either. We think the current geopolitical climate continues to be supportive for the Dollar for time being, but our long-term concerns remain. The renewed expansion of the Fed’s balance sheet is already an indication that liquidity in the U.S. Dollar market might increase and this has typically been negative for the currency. So while the USD holds up really well for now, we see possible weakness ahead, as economic growth might disappoint further in Q1 and Q2 of the new year.

We would also like to reiterate a key point that we highlighted in our last InSights too, which still is very relevant: global investments continue to look much more attractive from a valuation point of view than their American counterparts. U.S. markets still look expensive and with the recent earnings revisions, this might be even more true now than it was a few months ago. From that perspective, we feel it is a great time to invest internationally and diversify globally. We are happy to help you with that and with any questions you might have in this regard. Feel free to contact us at info@bfiwealth.com, we look forward to hearing from you.

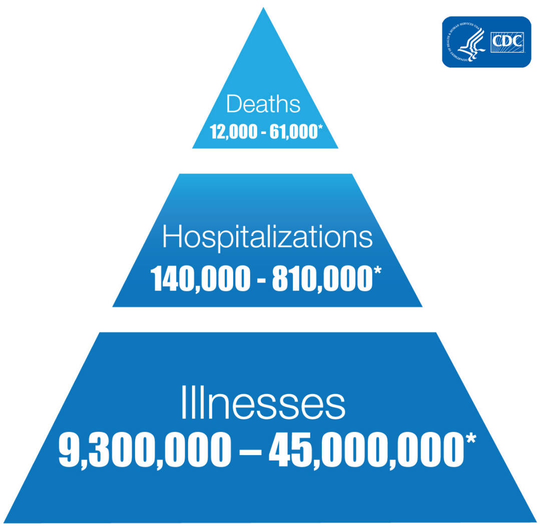
Outlook 2020: Opportunities and challenges ahead

Dirk Steinhoff
Chief Investment Officer

The first month of the new year already managed to introduce some added anxiety in equity markets and a volatility spike that spooked many investors. The news of the coronavirus and the fear of it rapidly spreading from China to the West and to the rest of the world monopolized headlines for weeks and is still receiving worldwide media coverage.

And yet, at BFI Infinity, while we do appreciate the gravity of the threat and the potential human and economic cost, we also believe that the overall reaction to the news might be somewhat overhasty. Despite the bumpy ride that 2020 has started off with, at this point and with the information we have right now, we expect this phase to be rather short-lived, as there are reasons to expect that stock markets and the global economy will continue to be well supported going forward.

Annual impact of the flu season since 2010



Source: Centers for Disease Control and Prevention (CDC), Disease Burden of Influenza

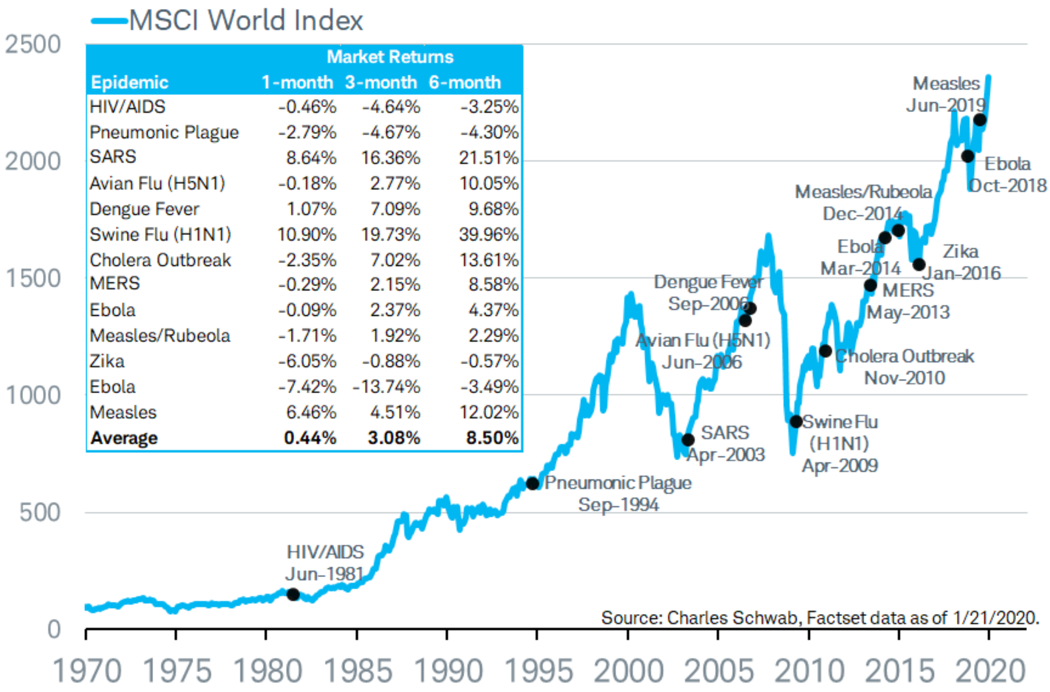
Short-term fears and volatility spikes

2020 started with a series of disconcerting news stories and developments that made many investors question whether the record-breaking bull market in U.S. equites might be coming to an abrupt end. The year began with the sudden spike in the tensions between the U.S. and Iran, a development that grabbed international headlines and saw the media echo fears of an imminent military conflict. Stock investors were startled and oil prices were pushed higher, but the effect was extraordinarily short-lived and the S&P 500 soon went back to breaking record highs again.

We now see similar coverage of the coronavirus threat. Of course, there have been thousands of confirmed cases and the fatalities from the virus are indeed well documented and newsworthy. However, mass media reports tend to focus more on the number of patients infected and on the new countries that the virus "invades", rather than the actual effects of the illness and the fatalities. From this perspective, the situation appears a lot less alarming. Without wishing to downplay the human cost, we must still recognize that out of more than 40,000 confirmed cases (as of February 10), the Wuhan virus has so far caused less than 920 deaths and most of them were older people or had preexisting conditions and weakened immune systems. Just to put these figures into perspective, in the U.S. alone, the flu season has annually caused between 9 million – 45 million illnesses, between 140,000 – 810,000 hospitalizations and between 12,000 – 61,000 deaths since 2010.

As for the economic ramifications of the Chinese virus, of course, we can expect the disease to take its toll there too. After all, supply chains have been interrupted, flights cancelled, borders closed, and factories shut down, and the effect of all these disruptions is by far not negligible. Nevertheless, it is important to evaluate the overall economic impact of the virus within the appropriate context. Even if the coronavirus does turn into a serious "flu-like" pandemic, historic data from similar events suggest

Effect of world epidemics on global stock markets



	Market Returns		
Epidemic	**1-month**	**3-month**	**6-month**
HIV/AIDS	-0.46%	-4.64%	-3.25%
Pneumonic Plague	-2.79%	-4.67%	-4.30%
SARS	8.64%	16.36%	21.51%
Avian Flu (H5N1)	-0.18%	2.77%	10.05%
Dengue Fever	1.07%	7.09%	9.68%
Swine Flu (H1N1)	10.90%	19.73%	39.96%
Cholera Outbreak	-2.35%	7.02%	13.61%
MERS	-0.29%	2.15%	8.58%
Ebola	-0.09%	2.37%	4.37%
Measles/Rubeola	-1.71%	1.92%	2.29%
Zika	-6.05%	-0.88%	-0.57%
Ebola	-7.42%	-13.74%	-3.49%
Measles	6.46%	4.51%	12.02%
Average	**0.44%**	**3.08%**	**8.50%**

Source: Marketwatch, Charles Schwab

their effect on the economy and on stock markets is actually rather limited and rarely lasting. One such example is the reaction to the SARS virus, that killed over 770 people back in 2002-03. According to Dow Jones Market Data, the S&P 500 posted a 14.59% gain in the six months after the first occurrence of SARS and a year later, it was up 20.76%. As can be seen in the chart above, a similar picture is painted by other recent outbreaks.

Therefore, we do feel that the reaction to the coronavirus threat is likely exaggerated, at least based on the information that is available at this stage. The circumstances may change and new research may reveal more worrying facts about the illness, that could indeed warrant decisive defensive moves by investors. However, until then, the wisest strategy is to remain composed and to make decisions based on the facts and not on mere fear and public panic. After all, the media does have a way of fueling such sentiments by exaggerating potential threats. News outlets need to grab the audience's attention to secure advertising revenue and nothing works better than sensationalism and dramatic headlines.

A very recent example can be found in the coverage of Brexit. For over two years, the UK's departure from the EU was often painted as a catastrophic scenario, with near-apocalyptic warnings, ranging from a full recession to food shortages. And yet, none of these extreme calamities managed to manifest, while very little coverage and attention was given to the country's actual departure at the end of January.

Monetary policy support

For us at BFI Infinity, the real story that could very well come to define 2020 lies far beyond the attention-grabbing headlines we mentioned above. It is a slow and steady trend that has re-developed over the last year and appears set to continue into the new one. All major central banks have returned to the easing path and seem determined to stay on it for the foreseeable future. This dovish direction means that asset buying, as well as negative and close-to-zero interest rates are here to stay.

In Europe, the ECB has plainly laid out its plans, with its new President, Christine Lagarde, being committed to follow her predecessor's footsteps in supporting the Eurozone economy. After resuming its asset purchasing program last November, the central bank is set to keep buying €20 billion worth of bonds every month, a policy that is expected to last at least another year. As for its interest rate policy, following the most recent cut that went further into negative territory, there is no reason to believe that a reversal is coming any time soon.

There is a similar monetary landscape over in Japan. At its last meeting in mid-January, the Bank of Japan (BoJ) kept monetary policy steady, with its short-term interest rate target at -0.1% and a pledge to keep 10-year government bond yields around 0%. The BoJ also reiterated its intention to keep interest rates at the current low levels for longer, or even cut them further, if the need arises.

Meanwhile, the Peoples' Bank of China (PBoC), the Chinese central bank, has also swiftly returned to a supportive policy path. The country's growth target of around 6% was already seen by many economists as unrealistic, even before the emergence of the coronavirus, as the economy had been weakened by the US trade war and by severe internal problems, including corporate debt defaults reaching a record high in 2019. However, the spread of the virus did pile on the pressure for the central bank to act in order to restore investor confidence and help absorb the impact of the disease. Since then, the PBoC has already injected over 1.7 trillion yuan ($242.74 billion) into the financial system through open market operations and according to reports by Reuters, "China's central bank is likely to lower its key lending rate - the loan prime rate (LPR) - on Feb. 20, and cut banks' reserve requirement ratios (RRRs) in the coming weeks".

Nevertheless, it is probably the Federal Reserve that has performed the most striking U-turn in its policy direction. Just over the last couple of years, the central bank has gone from pledges of interest rate normalization and Quantitative Tightening plans back to rate cuts and regular cash injections into the financial system through its repo operations. This policy reversal, although not directly acknowledged by Fed officials for what it is, namely a return to quantitative easing, has nevertheless provided significant support for stock markets and is bound to continue to do so. Throughout 2019, cheap borrowing costs have facilitated stock buybacks that in many cases helped push valuations higher, with earnings per share going up even without improving or declining earnings. At the same time, official announcements by the bank and forward guidances have reassured investors that monetary support will not be withdrawn any time soon.

Overall, this fresh global liquidity wave is bound to be supportive for stock markets. As can be seen in the chart below, there is a strong correlation between the global money supply and the MSCI World Index

Global money supply (white) and the MSCI World Index (yellow)

Source: Bloomberg

and so far, we've seen money supply increases move almost in lockstep with the stock market rally. This effect is very likely to persist, as all major central banks are set to continue, and perhaps even double down on, these expansionary policies.

Cautious optimism and potential caveats

Overall, we do expect that the return of central bank support across the board can help set the stage for another good year in equities, bonds and precious metals. That being said, it might prove challenging to replicate the performance of the last year and we generally anticipate higher volatility levels. We are, after all, at a late stage in the current economic cycle and it can be argued that the expansion is already overstretched. This has given many investors a good reason to pay more attention to downside protection and to defensive strategies, hence the recent spike in demand for safe havens, such as gold and the Swiss Franc.

Thus, in this climate of somewhat heightened anxiety, a stock market correction wouldn't be too surprising. Nevertheless, the considerable support provided by ultra-low interest rates and fresh central bank liquidity is bound to soften the blow and could manage to stave off a recession. On top of that, it is also important to remember that 2020 is an election year in the U.S., which tends to lift stock markets. For each of the 23 election years since 1928, the S&P 500 has only delivered negative returns in just four of them. Furthermore, we must also bear in mind that the centenary of the founding of the Communist Party of China is coming up in 2021. The political and cultural significance of this can hardly be overstated and state officials will most likely do everything they can to make this year a great economic success.

Despite this overall positive outlook, we do see certain risk factors that could threaten to derail it. These might be relatively low-probability events, but it is still important that investors bear them in mind and factor them into their strategy. For example, a very serious challenge could be presented by a spike in oil prices. After the sustained low levels of the last years, this might seem like a far-fetched scenario and perhaps it is, but there have been relevant developments that went largely unnoticed over the last year. U.S. shale production, for instance, has tapered off, after a decade of break-neck acceleration. In the event of an oil price surge, a resulting inflation spike, a scenario that has been underestimated for way too long, could prove extremely damaging for the global economy at large and for the central banks' capacity to keep interest rates low.

Another considerable risk could be presented by an increase in corporate debt downgrades and defaults. The ultra-low interest rate environment of the past decade has encouraged a borrowing binge that has resulted in a record amount of global junk debt, that investors are keen to buy in search of the ever-elusive yield of the last years. In January, new bond sales by the riskiest corporate borrowers hit a record \$73.6bn that exceeded any monthly total over the last 25 years. Fears of defaults are understandably on the rise, as are the concerns over a wave of downgrades in the investment-grade territory. 2019 saw the share of BBB-rated bonds, the last level before dropping to the high-yield category, reach a record 50% of all outstanding investment-grade U.S. corporate bonds.

Bearing these risks in mind, and of course keeping a close eye on all relevant developments, our approach at BFI Infinity remains cautiously optimistic. We still see interesting opportunities in equities, especially in Europe, where valuations remain attractive compared to the U.S., but we are also prepared for potential volatility ahead with solid downside protection in place.

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