2020 Investment Strategy. Generally Cautious.

Reduce equity exposure.

Equity markets have outpaced fundamentals recently. In any reversion to mean, equities will perform in line with fundamentals which suggests a much more moderate performance in 2020. On that basis alone, investors should reduce equity exposure. By how much? In a balanced portfolio with 35% in equities and 65% in fixed income, one might reduce exposure to 25% in stages. The economy is experiencing a short term rebound which could impact monetary policy expectations and lead to a weaker market. Further out along the horizon weaker growth could lead to re-emergence of rate cut expectations which could propel markets to higher valuations.

Maintain a close allocation to the MSCI World.

Markets are very flow driven which helps the simplest allocation outperform more sophisticated ones. Over the long term one would expect China and India to outperform. Moderate over-weights in those countries at the expense of US make sense, but one should not deviate too much. Sector deviations can be volatile this year.

There is opportunity to outperform in fixed income.

Reduce EUR and JPY duration. The ECB and BoJ are exhausted. Japan and Europe will turn to fiscal policy for their economic support and this will mean higher yields across EUR and JPY yield curves.

USD duration is complicated. Maintain a neutral to underweight duration exposure. The Fed has room to cut and could do so if pressured by the President or if economic data weaken. Fiscal policy remains loose and both political parties are not focusing on fiscal prudence. This will likely steepen the USD curve.

Maintain neutral IG corporate credit exposure. There is still some return to be squeezed from corporate credit. In investment grade, the long duration (circa 6 to 8 years) may call for hedging.

In high yield rotate from bonds to loans. The general duration + credit spread trade has done well but is long in tooth. Leveraged loans are a better trade expression. Very low duration by reason of floating rate coupons, senior, secured, and higher in the priority of claim, loans are preferable to bonds.

There is some opportunity in CLOs.

CLOs repackage loans into a variety of liabilities from equity to mezzanine to senior. In the current environment, the liquidity and balance of credit risk in the BBB segment is attractive. The time for equity investment is not yet upon us but if the economy slows and corporate balance sheets get stressed, be ready to buy CLO equity or junior mezz.

Overweight residential mortgages in the US.

The relative credit quality of household balance sheets relative to corporates' or the states' makes agency residential mortgage backed securities an attractive investment. Even here, pricing is tight but relative to everything else, there is still safer yield to be harvested.

Bank subordinated capital.

Last year was a very strong year for so-called CoCos. However, the market is still relatively cheap compared to non-financial corporate credit.

Generally Cautious:

Hold a bit more cash in 2020 than in 2019. Resist the temptation to extend risk just to get that extra bit of yield.

Political risk is higher given the US Presidential elections.

Trump can be even more erratic as he seeks re-election. Sanders and Warren, while long term positive for the US economy will be a drag on growth and markets in the short term. In Japan, Prime Minister Abe is in his final term. The China US struggle continues. A trade deal is likely to be cosmetic and represent short lived détente.

Valuations are high, not only in equities but in credit. Liquid IG and HY corporate bonds are unattractive. Yes, one could expect markets to tighten 50 yo 60 basis points over the year, but the risks are asymmetrical with a higher chance of widening. The yield compression from capital inflows from ETFs and tourists is significant and thus also is the unwind risk. Once attractive areas where the more sophisticated investor squeezed returns, i.e. CoCos, CLOs, ABS, are now expensive. They are not as expensive as corporate debt but their additional complexity and somewhat lower liquidity demands a higher hurdle.

The economy is slowing. The next 6 to 9 months may see some improvement but this is likely to be temporary. There are new innovations driving the next leg of growth. The trade war has reduced the productive efficiency of the economy. The acute inequality in the world has reduced the allocative efficiency of the economy.

Central banks are at capacity. If there is any serious slowdown, the ECB and BoJ are already at their limits. They have cut rates to below zero and are still buying bonds. The US Fed may have stopped cutting rates but they are also still buying bonds. The PBOC is operating a comprehensive policy of easing. Central banks did not reset their policy tools soon enough after the last crisis and their capacity to support the economy is seriously diminished.

Too early for distressed investing. But do the homework now. There are areas of stress and distress even in a period of growth. The large cap defaults are likely to be deferred at the expense of recoveries. Caution is warranted. When the corporate defaults come, the scale may be substantial and could take markets by surprise.

Bank Regulation. Banking regulatory capital requirements continue to support bank disintermediation and or bank regulatory capital arbitrage. Private lending continues to be a good opportunity despite a good deal of spread compression. Focusing on credit quality, covenant strength and collateral quality is key. Trade finance and real estate finance are areas of interest. So too are mid market senior first lien loans.

Look for shorts. It is still too early for a turn in the economic or market cycle but scanning, filtering and looking for short ideas takes time and effort. Sometimes, they are easier to spot by their rarity.

Duration is not a haven. Fiscal policy is likely to push yields higher. Inflation may creep higher as the labour market gets tighter. Central banks being at the limits of efficacy also speak against duration. EUR and JPY duration are unattractive. USD duration is in an uncertain place. The Fed may cut further or extend the duration of their SOMA holdings but the balance of fiscal and monetary policy puts USD duration in a fine balance.

The repo market is showing signs of strain. When QE was initiated the term structure flattened. When QE was tapered, the expectation was that the curve would steepen back up. It flattened further instead. When the Fed balance sheet was actually shrunk, the term structure actually inverted. In September 2019, overnight repo briefly rose to 10%, well beyond the Fed fund's target range. This is an anomaly. The Fed has had to intervene in the repo market with large scale liquidity provision, and resume buying bonds at rate of 60 billion dollars a month, now increasing its balance sheet. They assure us this is not QE. It looks more like a QE trap.

Prefer safety over gain. Generally, prefer value over growth, dividends over capital gains, senior over junior, secured over unsecured, and quality over yield.