Incrementum All Seasons Fund

– in pursuit of real returns –

HGS own shot, 7.7.19, in loco

August 2019

Seasonal Reflections

(Soaring male condor, Colca Canyon, Peru (left), mimicked by the soaring spirits of equity investors due to unending monetary largesse (right)

https://twitter.com/qtrresearch/status/1153775116557398017?s=11

Dear Investor,

July was mainly a vacation month. As the heading suggests I took Alex' and the girls to Peru for three weeks (Lima, Arrequipa, Colca Canyon, Puno / Lake Titicaca, Cusco, Machu Picchu, Madre de Dios) which turned out a marvellous trip with great sceneries, an interesting history and very nice people.

Both prior and after our return we have been baking under extreme summer heat here in FL (though it has cooled off this week). The temperatures seem rather befitting currently boiling hot risk-asset prices… - It seems that every Tom (Jerome Powell?), Dick (Mario Draghi?) and Harry (Larry Fink?) is dancing around the campfire, holding hands and singing the mantra so beautifully composed, I assume, by Quoth The Raven Research LLC and displayed on the right side of the header: *"The stock market is a magical thing that makes u(s) rich & never goes down…"* – Welcome to La La Land!

BlackRock CEO Larry Fink says ECB must buy equities to stimulate euro zone

https://www.reuters.com/article/us-blackrock-fink/blackrock-ceo-larry-fink-says-ecb-must-buy-equities-to-stimulate-euro-zone-idUSKCN1UE26G

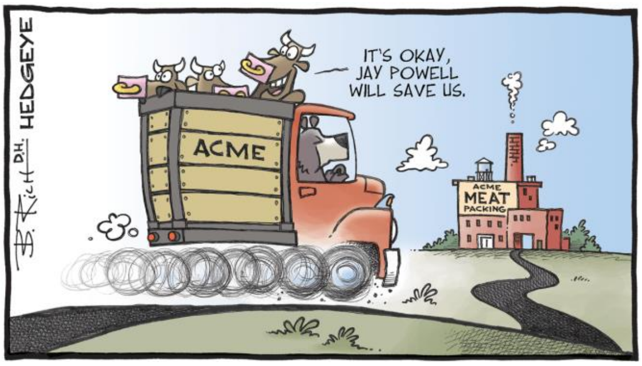
With headlines like the above, one cannot help but wondering whether all pretence of the notion of financial MARKETS has long been thrown overboard. After all, look who is talking… - the CEO of the largest asset manager in the world, which opens its corporate website (https://www.blackrock.com/corporate) with the following promise:

At BlackRock, we help you invest in your financial well-being.

And in that endeavour, it undoubtedly helps when central banks, after having driven the most important price in the world (i.e. interest rates) into the ground with their uneconomic and limitless buying, now also help to further lift stock markets. All for the financial well-being of BlackRock's clients, of course… (cough, cough…)

Meanwhile, our monetary mandarins know exactly what to do. To quote from the above linked-in (is *that* even a verb?) Reuters article:

"German news magazine Der Spiegel cited central bank sources on Friday as saying ECB President Mario Draghi planned to restart purchases of government bonds by November to support the fragile euro zone economy.



https://app.hedgeye.com/insights/75865-cartoon-of-the-day-dead-meat?type=cartoons

The magazine also said Draghi hoped the move would encourage companies to invest more and consumers to spend more."

My kids tend to comment something like this with LoL, which I was told is an abbreviation for "Laughing Out Loud". - As if this had worked over the past few years – in fact evidence would suggest the opposite effect (Japan, anyone?). But with self-serving influencers like Larry here, it's all turning into a giant gambling pit…

In case you care for more high-profile commentary on the state of global markets, David Rosenberg of Gluskin Sheff recently remarked in his "Espresso with Dave" (underscore mine):

"The fact that, in the USA in any event, we have valuations like price-to-earnings, the CAPE ratio and price-to-book all around 1 SD events doesn't seem to resonate much in a market where investors are convinced that central bankers have their backs. For all the talk of this bull market being the "most hated" ever, consider that Investors Intelligence poll pegs the bull camp at 54% and the bear share at 17%. Imagine what adoration would look like.

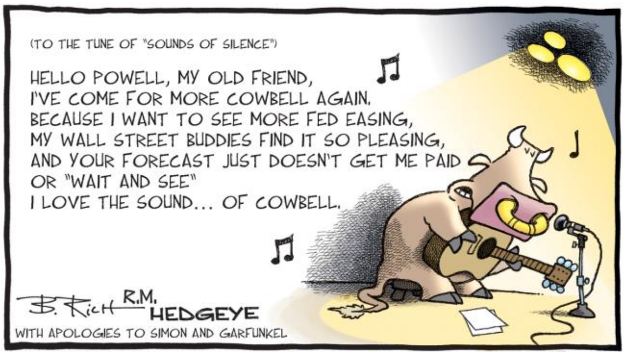
Bond markets, meanwhile, are staging rallies on their own that seems at complete odds with what equities are doing – or maybe both are feeding off the fumes of uber central bank accommodation. We have 12 central banks cutting rates so far this year and that doesn't even include the ECB or Fed just yet. So overnight we have German 10-year yields down 1.5 basis points to -0.40% (down now for seven days running); France down around 2 basis points to -0.14%; JGB yields dipped just a bit to -0.16%; gilt yields are down one beep to 0.67%. Sweden is the latest country to have its entire bond curve out to the 10-year maturity slip below zero to -0.074% (down almost 4 basis points today). Switzerland (-0.74%) and the Netherlands (-0.27%) have been there for some time and are heading further negative today. The yield on the 10-year T-note is down 1.6 basis points to 2.03% and remains the one-eyed king in the land of the blind.

Consider this nutty world we live in now where the yield on Greek 10-year debt is down to 1.96%, seven basis points through Treasuries. Why not? Spain, at 0.31%, and Portugal, at 0.38%, are more like 170 basis points through. Think about that – Spain is rated A- by S&P, Portugal is a BBB credit, and Greece is B+. Treasuries, even with all their warts, scars and pimples, have an average rating of AAA. <u>There is no textbook that teaches you how to invest in this type of environment where risk is a meaningless concept, and evaluating future cash flows only lead to asymptotic results when discount rates get to today's levels. Today's interest rate climate has rendered intrinsic value an oxymoron.</u>

…

[This is the most acute Potemkin rally in asset markets, and the economy, of all time. Without the rapid expansion of debt, there is no global economic growth to speak of. In fact, this 2009-2919 cycle makes a mockery of the debt bubble that formed from 2002 to 2007.] Central banks are playing the role of all the kings' horses and all the kings' men as Humpty Dumpty sits on this dangerous and unsustainable wall of debt. Global debt liabilities at all levels of society – household, business and government – ballooned $3 trillion alone in 2019Q1 and now totals $250 trillion (with a big fat 'T'), or an amazing 320% of world GDP. [Ever think that gets repaid?] And to think the bright lights in Washington believe that continuous increases in the debt ceiling are a good thing. They clearly don't know their history, or simply don't care since they won't be around to clean up the mess." (Source: Gluskin Sheff, Espresso with Dave, July 25, 2019)

Yes, I'm afraid this is the world we live in – the only thing that matters to investors is "more cowbell" ("More Cowbell" is a comedy sketch that aired on Saturday Night Live on April 8, 2000. For the uninitiated reader, you may want to visit https://www.youtube.com/watch?v=cVsQLlk-T0s for a highly entertaining 5 minutes video … - Readers can just replace Christopher Walken with any member of our League Of Central Bankers so appropriately depicted below…



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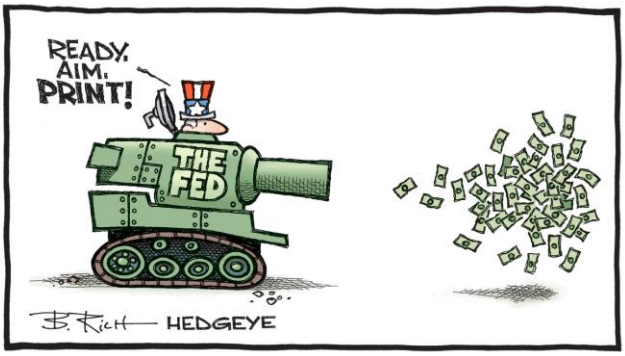

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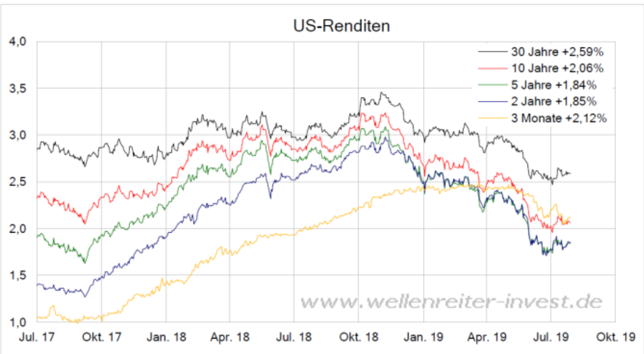
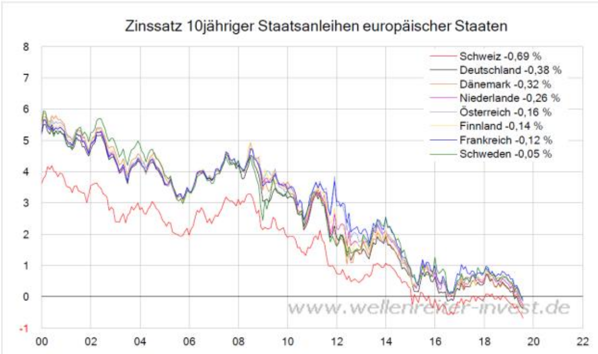
(Special thanks to Hedgeye, who let their cartoons speak so marvellously on the entire subject…)



Source: Der Wellenreiter – 30. Juli 2019 (https://www.wellenreiter-invest.de)

So this is what has been guiding investors this year: The promise of more asset purchases (i.e. market intervention) by global central banks, which have led to a steep decline in US-yields across the maturity spectrum (see chart on the left; yields have dropped another 20bp since), as well as a complete disappearance of positive yields for high quality 10-year government bonds in Europe. For the latter please refer to the graph on top of the next page which speaks volumes.

Quite obviously, investors in anticipation of a resumption of asset purchase programs have been encouraged to front run the central banks. This is all that these policies will ever achieve: The provision of cheap capital to boost asset prices and as derivatives spending, imports and investment – with a very unpredictable effect on an aggregate measure of consumer prices amid still significant overcapacity in the global economy and too little real growth.



Source: Der Wellenreiter – 30. Juli 2019 (https://www.wellenreiter-invest.de)

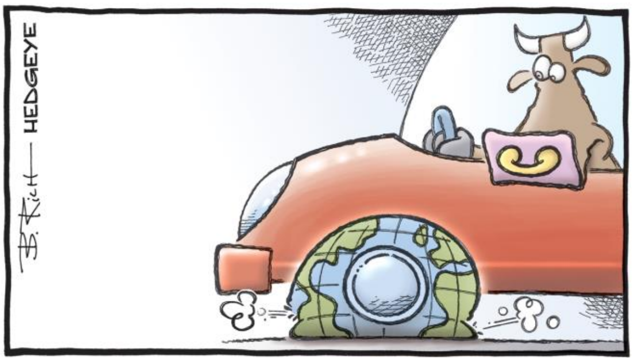
But make no mistake: *«The issue is not some "disease of low inflation". There's plenty of inflation, it's just neither uniform nor necessarily in all the avenues central bankers prefer. There has been strong inflation in securities prices, with the term "hyperinflation" fitting for some global bond markets (i.e. Italy, Greece, Portugal, Spain, Slovenia, etc.). Global stock prices are locked in a powerful late-cycle (speculative) inflation dynamic. Global real estate markets remain in a strong inflationary environment, along with asset prices more generally. The price dynamic for high-end collectables is hyperinflationary.»* (Source: Fanning the Flames, Credit Bubble Bulletin, 27 July 2019)

https://www.focus.de/finanzen/boerse/experten/gastbeitrag-von-gabor-steingart-diese-zeichen-zeigen-die-ezb-plant-das-helikoptergeld-fuer-alle_id_10972085.html

These policies of Keynesian-spirited «Euthanasia of the Rentier» have had one major, yet rarely discussed effect: German DZ Bank has recently published a study which was quoted in German business weekly Focus on July 30, showing that German private households lost EUR 358bn (approx. 1% of GDP p.a.) of interest income between 2010 and 2019 amid artificially depressed interest rates. This almost exactly represents the level of savings the government enjoyed and proves that these policies are benefiting debtors while harming savers.

And as the case of Japan has amply demonstrated over the past decades, the «unanticipated» effect is that prudent households save more in order to compensate for the loss of interest income.

Meanwhile, corporations see far more benefits from engaging in financial engineering (borrowing money to buyback stocks) than investing in their business amid an overall sluggish economy. And so global growth slows both structurally as well as cyclically, further weakening the fundamental underpinnings of today's risk asset pricing. For a critical view on the whole subject readers may refer to https://www.nytimes.com/2019/07/29/opinion/fed-interest-rates.html …



https://app.hedgeye.com/insights/76375-cartoon-of-the-day-flat?type=cartoons

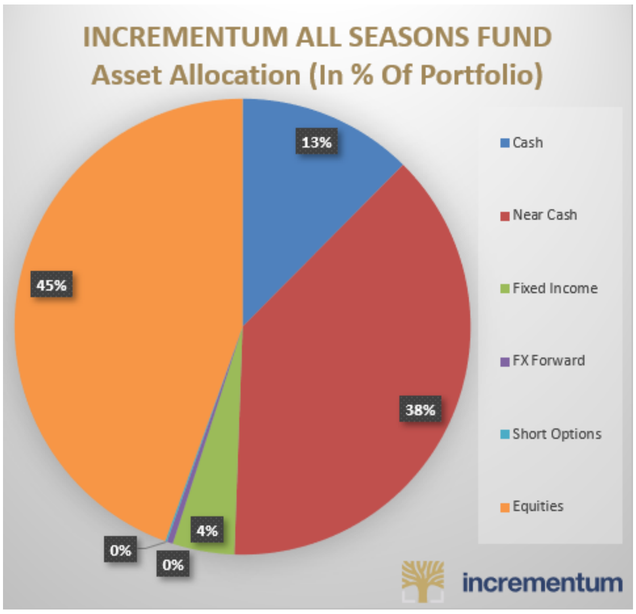
In my view, this is the most dangerous market environment I have ever experienced…

IASF Manager Review

Based on the above, July was a challenging month for IASF. First of all, the fund still saw further inflows (approx. EUR 3.37m), **lifting total assets to EUR 32.24m** at the end of July. That added cash, which as indicated above already, is hard to deploy with low risk these days. To quote the always candid Jim Grant (underscore mine):

"As noted by Bianco Research last Tuesday, almost 95% of developed market sovereign debt around the world is quoted at yields below the 2.40% Fed funds rate, up from 40% in 2015. According to Deutsche Bank, roughly 25% of all worldwide bonds trade at nominal yields below zero, including some corporate issues rated as low as single-B (well into junk territory), per BofA Merrill Lynch. As a reminder, negative nominal yields of even long-dated sovereign bonds are unheard of in 4,000 years of financial history prior to this cycle." (Source: Almost Daily Grants, Golden Years, Tuesday, July 30, 2019)

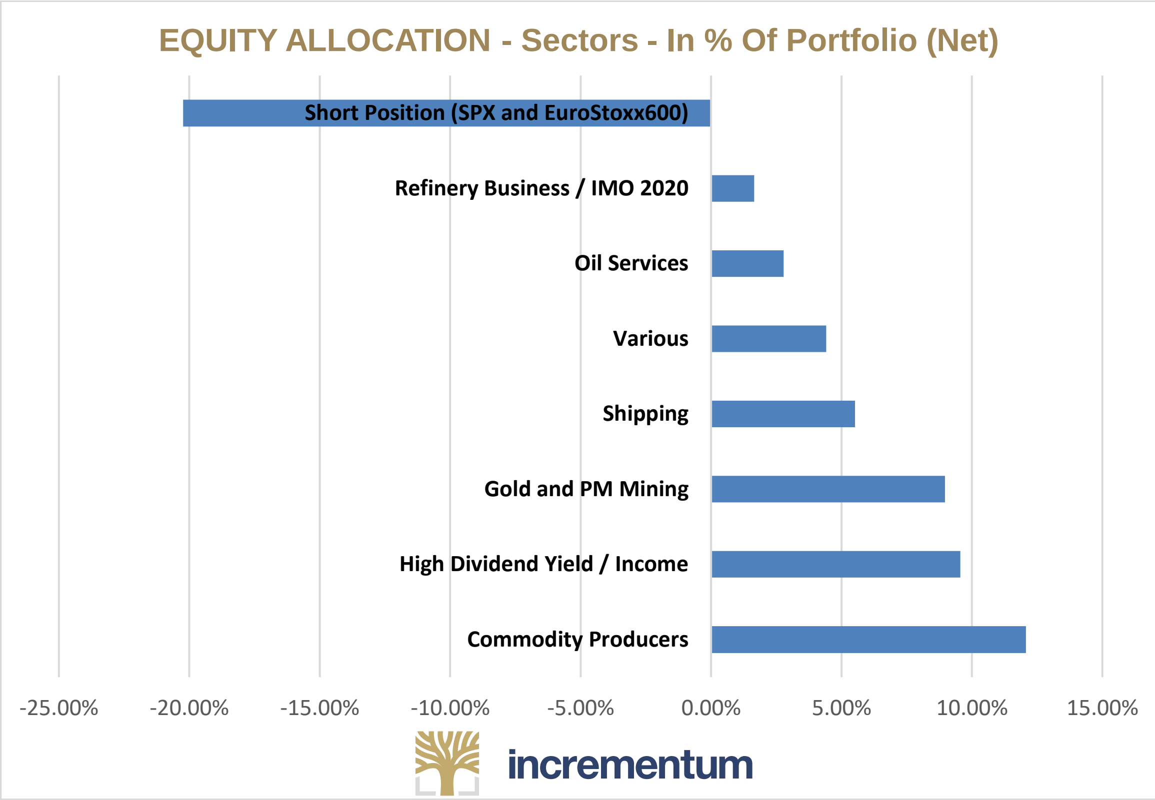
In other words, one of the fund's main challenges right now is to achieve any kind of meaningful (nominal) return on its cash position. The fund has thus begun selling e.g. FX options on EURNOK, EURSEK, EURGBP and GBPUSD, which has generated at least some income. All positions are still around the money, and thus may or may not lead to a delivery in August. The fund has also sold Put Options on BT Group, which are still out of the money at the time of writing and yielded a decent premium. The sale of call options on its Gold Fields ADR position on the other hand marginally failed to reach the set limit and thus did not materialize. However, this may help to explain how the fund is trying to use derivatives to generate additional income on its still sizeable liquidity position.



I guess this is an appropriate time to review IASF present asset allocation. As the chart shows, the fund is still rather defensively positioned, with **51% in cash and near cash** (fixed deposits, short-term bonds [<1y] and Gold and Silver ETFS). This is **down from 56% at the end of June**. The **bond position is at 4%** (down from 5% at the end of June amid larger assets size). The **equity allocation has grown from 39% at the end of June to 45% (gross!)** presently. The residual positions at the bottom of the page represent a -0.43% (loss) position due to an accumulated loss on a partial USD/EUR hedge (for more detail please refer to the currency allocation comments), and a -0.13% position in short option contracts.

The latter are always shown as a loss (liability) in the portfolio, because the sale of option contracts leads to the immediate receipt of cash premiums which are promptly added to the fund's liquidity position.

Let's have a look at the fund's risk asset exposure, i.e. equities. For ease of reference and as the graph below shows I have split the current equity allocation into specific themes.



Not surprisingly, **commodity producers** lead the pack **with a 12.1% allocation** (based on total portfolio assets), which compares with 9% at the end of June. The sector looks very much like the old-economy stocks of the late 90s, and in a world that desperately tries to reflate should be well-placed to perform relatively well over the conclusion of the cycle. Over the course of the month IASF sold small positions in Hudbay Minerals, Tassal Group, Steel Dynamics and Nutrien, while adding to positions in Lundin Mining (copper producer) and Husky Energy (integrated oil and gas). New additions to this segment were made with an initiation of Albermarle (largest and lowest-cost lithium producer) and Aurubis (German based copper refining and recycling business).

The next largest group are **high dividend yield and income focussed holdings (9.6%)**. This segment consists mostly of shareholdings transferred into IASF in 2H of June, with the largest holdings being the Invesco Morningstar US Energy Infrastructure MLP ETF (2.3%), followed by Hutchison Port Holdings Trust (1.6%) and Telefonica and Singapore Telecom (1.1% each). One "new" holding is BT Group, which not only pays over 8% in net dividends, but also is an excellent play on a turnaround under new management and given its rather depressed valuations.

Gold and precious metals mining stocks are the third largest category **with an allocation of 9%** (unchanged from last month). Largest holdings are Gold Fields ADR (2.2%) following a very strong rally over the past two months, Newmont Goldcorp (1.9%) and Wheaton Precious Metals (1.7%). Newly introduced was a small position in Equinox Gold, which is led by Pan American founder Ross Beaty.

Other investment themes include **shipping** and **oil services**, sectors that are both cyclically bombed out. IASF has also initiated a small new allocation to two **refineries** (Marathon Petroleum and Cosmo Energy), who should benefit from the new **IMO 2020** rules that require shipping companies to use low phosphate fuels (mainly marine diesel) from next year on, which should be an advantage for modern refineries with more flexible production facilities. New positions in the category “**Various**” are LM Ericsson B, which is one of the main 5G infrastructure plays (especially after Huawei has seen its competitive position curtailed politically), and CK Hutchison Holdings, which with its wide-spanned global operations will be a prime beneficiary of an eventual USD weakness.

However, a net equity quota of 45% sounds more aggressive than it actually is. This is attributable to a 20.2% short position (mainly [~82%] S&P500 Futures, balance EuroStoxx600 Futures), which explains the left stretching bar shown in the equity allocation graph on the previous page. Consequently, this leaves IASF with a **net long equity exposure of approx. 25%.**

https://markets.ft.com/data/indices/tearsheet/charts?s=AW01:FSI

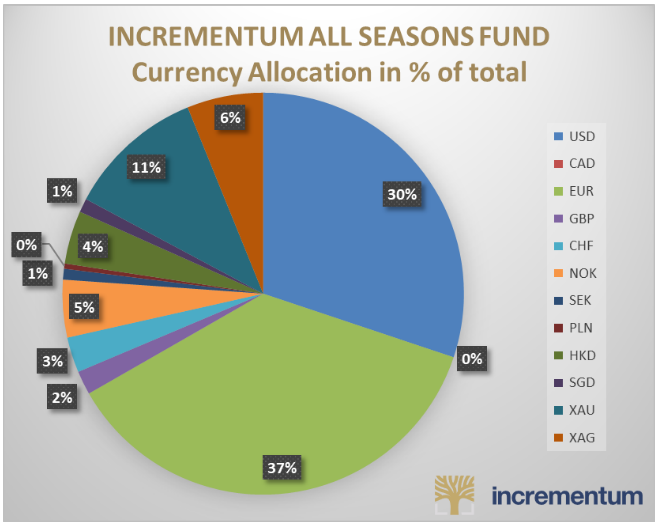
https://app.hedgeye.com/insights/76351-cartoon-of-the-day-sigh?type=cartoons

Looking at long-term equity market graphs one can hardly deny that global equities are cyclically elevated (see graph above), which even bullish investors may note with a sigh of worry… - Consequently, **IASF is using short futures positions to hedge** against a near-term (also seasonally driven) broad market decline. This alloation has been increased just yesterday (31.7.) by doubling the S&P500 short exposure, and at -20% is **up from -8% at the end of June**. Futures positions are cash-settled via daily bookings of variation margin into IASF’s accounts, and thus the impact of these positions on overall asset allocation happens instantly and profit / loss are realized on a daily basis. Right now, I reckon a 25% net equity allocation is appropriate, while the fund maintains larger gross exposure to equities which I regard as relatively defensively at their current levels.

One last comment concerning asset allocation: I have been looking at adding a managed futures program to the fund, which has been doing extremely well this year. The problem is that that particular fund right now is fully risk-on positioned. Typically, such vehicles tend to experience NAV corrections in any short-term market regime shift, simply because it takes time to recognize a shift towards a correction- / risk-off mode, and then to reposition holdings accordingly. This is why I have so far hesitated to initiate this position, though the fund is targeting a medium-term 5% allocation to this fund (and possibly up to 10% to the asset class, provided another suitable vehicle can be identified).

Ok, let’s turn to the final part of the management review section, which deals with IASF’s FX allocation:

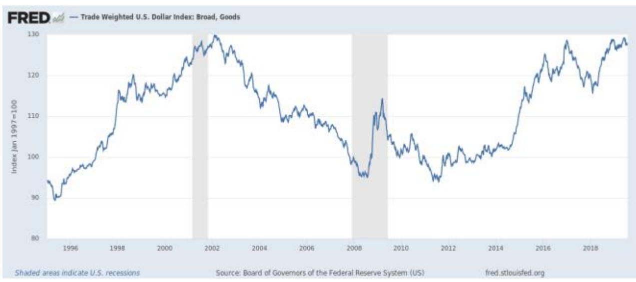
On a look-through basis, the EUR denominated IASF portfolio currently has the net FX allocation shown below:



Despite of a partial USD hedge of approx. 17%, the portfolio maintains an effective USD allocation of approx. 30%, plus another 4.3% in HK. This is partly due to the fact that I have rated USD-based commodity producers, shipping, oil services and refinery stocks that are EUR, GBP, DKK, NOK or CAD listed as USD exposure. A shipping company like Stolt Nielsen for example that runs a global network of chemical tankers and storage facilities does report its financials in USD, even if its shares are listed in Norway and denominated in NOK. Hence its NAV and annual results should actually benefit from a rising USD versus NOK and vice versa.

As equity (and global financial) markets are anything but efficient, this is obviously not always the case. Thus, I find it especially important to determine the actual "economic" FX exposure of each business, which is why I have adjusted the allocation provided by IASF's custodian bank LLB accordingly. This is also true for Gold and Silver, which in my view represent currency. Consequently, there is a gold allocation, which is made up of IASF's ETFS Gold holding (4.9%), plus another 6.2% in gold mining company exposure (i.e. ASA, Equinox, Gold Fields, Iamgold, Newmont GoldCorp and Sibanye Stillwater), deriving a total 11.1% effective exposure to gold [XAU]. Similarly, the silver allocation consists of a 3.4% ETFS Silver holding, as well as IASF's 2.8% combined exposure to Pan American Silver and Wheaton Precious Metals, yielding an effective 6.2% total silver allocation.

All in all, the fund's FX allocation is well-diversified and though the USD clearly looks toppish at its present levels (and with the Fed's first 25bp cut just in the bag), I think the 30% allocation to USD is not too aggressive at this stage as a significant part of this derives from commodity producers who tend to benefit from falling USD FX rates.



Source: https://fred.stlouisfed.org/series/TWEXB#

For now, it is not even clear whether the USD will not attempt one more push higher given the "relatively" hawkish comments of a "mid-cycle adjustment" by Jerome Powell last night. Hence this appears for now an appropriate portfolio allocation. After all, uncertainties about US-China trade negotiations, Brexit, and an overall lacklustre growth outlook all may weigh heavily on overbought equity and bond markets over the coming months.

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Closing thoughts

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https://app.hedgeye.com/insights/76643-cartoon-of-the-day-trade-deal?type=cartoons

We are living in a debt-fuelled speculative bubble, floating on a sea of complacency (see also https://themarket.ch/meinung/the-bubble-in-complacency-ld.499), which arguably is not the soundest foundation to build one's portfolio on and which in turn makes this such a difficult time to invest. But I have long learnt to accept what the markets are offering me, and overall investors should not have done too badly this year.

Of course, IASF only looks back at a good 6 weeks of actual investment history (at least as far as the "D" shares are concerned), and we will have to wait and see how the portfolio will behave over the rest of the year, which may still have a few surprises on hand. For those who would like to have a look at the actual performance graphs of their relevant share classes, I have attached them as Appendix for your further information, which I trust you will find useful.

Greetings from Schaan, Liechtenstein!

Hans

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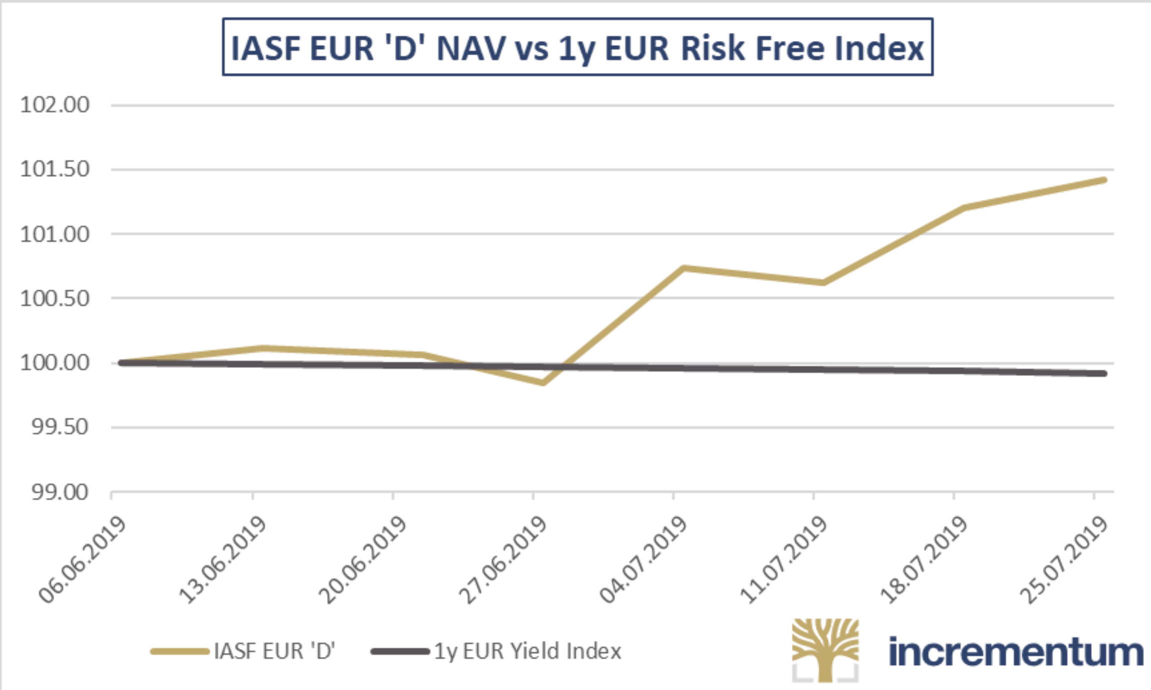
Appendix *


IASF EUR 'D' NAV vs 1y EUR Risk Free Index
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IASF EUR 'D'
1y EUR Yield Index
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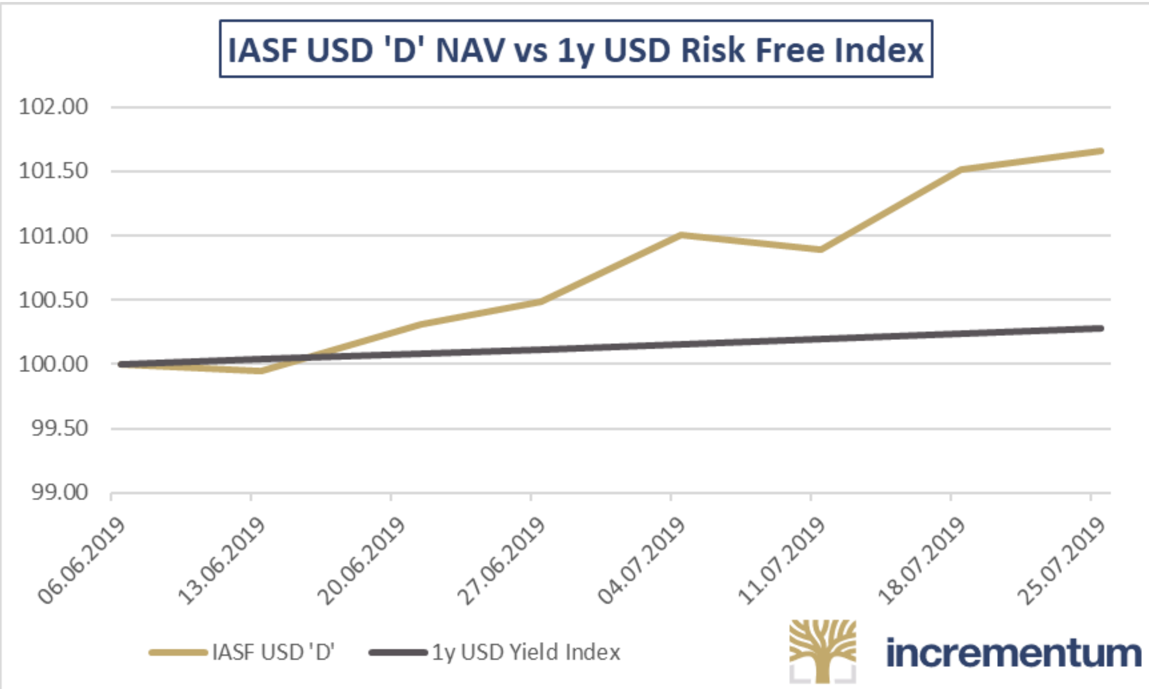
IASF USD 'D' NAV vs 1y USD Risk Free Index
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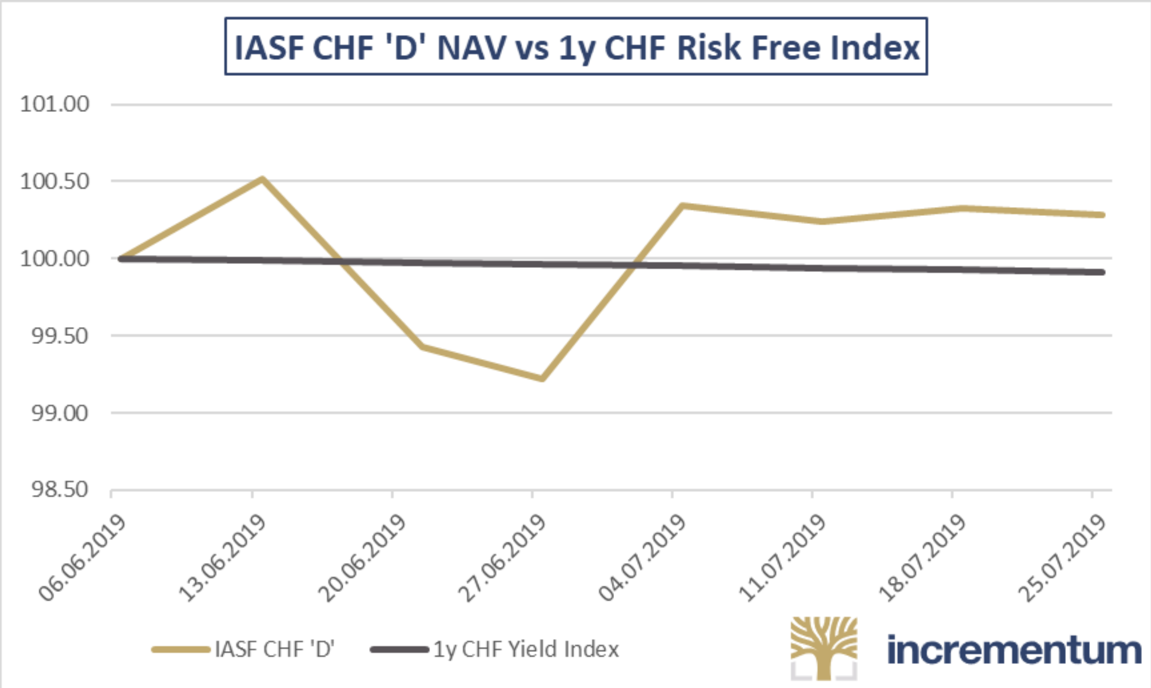

* Graphs display NAV of IASF 'D' shares compared to the respective risk-free 1y-government yield at the start of the investment period (6. June 2019) on an indexed basis.

Disclaimer

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Past performance is not a guide to future performance. Values may fall as well as rise and you may not get back the amount you invested. Income from investments may fluctuate. Changes in rates of exchange may have an adverse effect on the value, price or income of investments. You should obtain professional advice on the risks of the investment and its tax implications, where appropriate, before proceeding with any investment.