

CEO Corner

Uncharted territory: Go where no one has gone before



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Since our [June update](#), equity markets have continued to recover despite the fact that most major economies saw a sharp contraction during Q2/2020. While the contraction in Europe was still below 10%, the economic crisis in the U.S. has been more severe with much higher levels of unemployment. Central banks

and governments around the world have started to provide monetary and fiscal stimulus like never before.

“Whatever it takes” probably describes it best. All the flood gates are now open and while this will certainly help to dampen the negative consequences in the short run, the true cost will eventually be brutal with record amounts of government debt and a massive destruction of purchasing power of fiat currencies. In order to successfully navigate these rough waters, it is essential not to lose track of the big picture developments and it is absolutely crucial that investors understand the long-term implications. For this purpose, we are preparing an extensive special report, entitled “On the brink of a new era – are you prepared?”. Please contact us if you would like to receive a copy. While our special report will take a longer-term view, we will focus here on what is ahead of us in the coming months.

It may seem counterintuitive to most people that equity markets have recovered so strongly, while most major economies remain in recession mode, even though the current quarter certainly looks stronger than the last. Some equity markets have entirely erased the losses from the covid selloff, while others are getting closer to a full recovery. But how can that be? Are we seeing a complete decoupling of financial markets from economic reality?

At first glance, it certainly looks that way, but when we take a closer look it is all starting to make more sense. The strong recovery of equity markets is yet another sign of the gigantic asset price inflation that we have been seeing for more than a decade now. The only difference now is that asset price inflation might have shifted into a higher gear recently due to the enormous amounts of fiscal and monetary stimulus that is provided worldwide. Of course, most of this is done by issuing additional debt and simply just printing money out of thin air. Federal Reserve Chairman Jerome Powell recently announced the Fed’s new strategy and the central bank’s intention to tolerate significantly higher levels of inflation in the future, so the 2% target inflation will not be as important going forward.

There is also a lot of talk about new large fiscal stimulus packages being announced, especially in the U.S. and in Europe. Fiscal stimulus is also an important topic in the heated political discussions in the U.S. between Republicans and Democrats. While the two parties have very different views on a lot of things, it is clear that both will increase spending even more going forward. Remember, for more than 20 years in a row, we’ve seen deficit after deficit and that pattern held during a very strong economic period, so it is virtually impossible that this will change now, in the face of the current crisis or its aftermath.

Historic overvaluation of U.S. stocks relative to the rest of the world

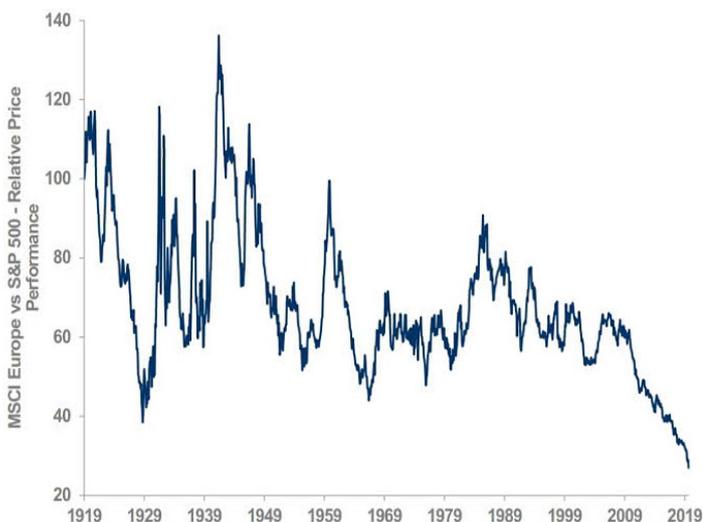
It would be naive to think that the dramatic fiscal and monetary measures will not have consequences in the future. While consumer price inflation might still remain subdued for some time, asset price inflation will continue to rise and probably reach levels in the coming years that might have seemed impossible not too long ago. Therefore, we feel that investors have to hold assets that are well positioned for this prolonged asset price inflation. Even with the currently high and stretched equities valuations, it remains essential to

be invested in stocks, as they will be supported by the reflation of the global financial system.

Two things are really important with regards to equity investments. First and foremost, investors have to be very selective in terms of what stocks they are picking. While there is a strong case for continued asset price inflation, it is crucial to follow a strict screening process and to realize where and when valuations may become overstretched. An important criterion in our selection process remains the balance sheet quality of companies that we are investing in and here we are applying very strict standards. This often leaves us with just a small number of stocks that we like, but we still insist on high quality stocks and healthy companies. Since the global economy might not be back to normal for another year or two, we always have to ask whether a company can really deal with this prolonged uncertainty and reduced business activity.

Secondly, geographical diversification is quickly becoming imperative for any portfolio. The U.S. stock market currently looks heavily overvalued by pretty much every known valuation method. In fact, the valuation difference between U.S. and international stocks recently hit a 100 year high! The chart below shows the relative price performance of U.S. stocks versus European stocks, and it seems to be clear that this trend will eventually revert back to the mean.

European stocks at a 100-year low relative to U.S. equities



Source: Morgan Stanley Research

This is supported by the fact that U.S. equity performance is heavily influenced by a small number of growth stocks (FAANGs), but also by the increased vulnerability of many U.S. companies, given the massive leveraging of balance sheets in Corporate America over the last decade. As a result, the current valuation gap between U.S. markets and the rest of the world certainly presents a very compelling opportunity to diversify internationally. While we are seeing breath-taking valuations in the U.S. tech sector, we see plenty of interesting investments globally that seem to be much more attractive and reasonably valued.

Other asset classes that stand to benefit from the reflation of the global financial system are commodities, precious metals and real estate. We have already covered the last two areas extensively in [previous issues of the InSights](#) and that is why we have chosen to focus on commodities this time and to take a closer look at the relevant investment opportunities in the second part of this report.

Playing good defense continues to be the name of the game

While our longer-term outlook for stocks continues to be positive, investors need to realize that investing in equities is going to be a different game in the years to come. Simply buy and hold the market is not going to work well anymore, since not all pockets of the market offer good value. Therefore, our strategy involves effective diversification in areas where we have strong conviction, without diversifying at the expense of that conviction.

In our understanding of good investment management, it is also clear that it isn't enough to simply look at the long side of investing, but also to hedge broader market exposure, realizing that short-term corrections of more than 5% are probably going to happen more often as valuations around the world are going to go up. We often apply put options to our client portfolios realizing that such short-term pullbacks can really hurt a portfolio and that in the long run, generating a superior performance is more dependent on what we do during times of market corrections. When markets go up, it is a lot easier to be a money manager.

By historical standards, many of these valuations might suggest that markets are increasingly overvalued, but it is important to note that this is only relative to historical levels. We probably have to get used to valuations that might look stretched, but are actually more and more reflective of a new normal. After all, in a world of slow growth, companies that can actually turn a profit are getting increasingly scarce and are thus being chased by more investors around the world. The current valuations in the U.S. tech sector seem to be a prime example. In our view, it wouldn't take much for the sentiment of investors towards these companies to shift, causing a selling wave in these stocks. This would push down U.S. markets very significantly.

We continue to be positive on precious metals, as gold has already been testing the USD 2'000 mark and silver has come back strongly as well. We see precious metals being well supported and we find it hard to find arguments against a continued bull market, given all the monetary and fiscal flood gates that are now open. As the downside of gold seems to be very well supported, we feel that prices of even USD 2'500 in the coming 24 months are not unrealistic. This is especially likely should there be more pressure building on the U.S. Dollar. Our long-term outlook for the Dollar remains negative, but in the short run it might be holding up for a little longer. This, however, does not change our strategy as we continue to diversify away from the U.S. Dollar, since we don't have much confidence in the currency's long-term prospects.

This is a very challenging time for the world, for all of us, but we are now seeing real opportunities for the future. While this is a fascinating time for an investment manager, the part that we enjoy the most is working with our clients and helping them navigate these rough waters. We feel this 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. Please contact us at info@bfiwealth.com, we look forward to hearing from you.

Commodities: A tectonic shift underway



Dirk Steinhoff
Chief Investment Officer

The last decade has presented excellent opportunities and considerable gains for equities investors, as the longest bull market in history, starting in March 2009, created a “tide” that lifted almost all sectors. In the commodity sector, however, the conditions were entirely

different. Weak commodity prices led to both weak prices of commodity related stocks and a widespread underinvestment in this sector. Now, this may all be about to change.

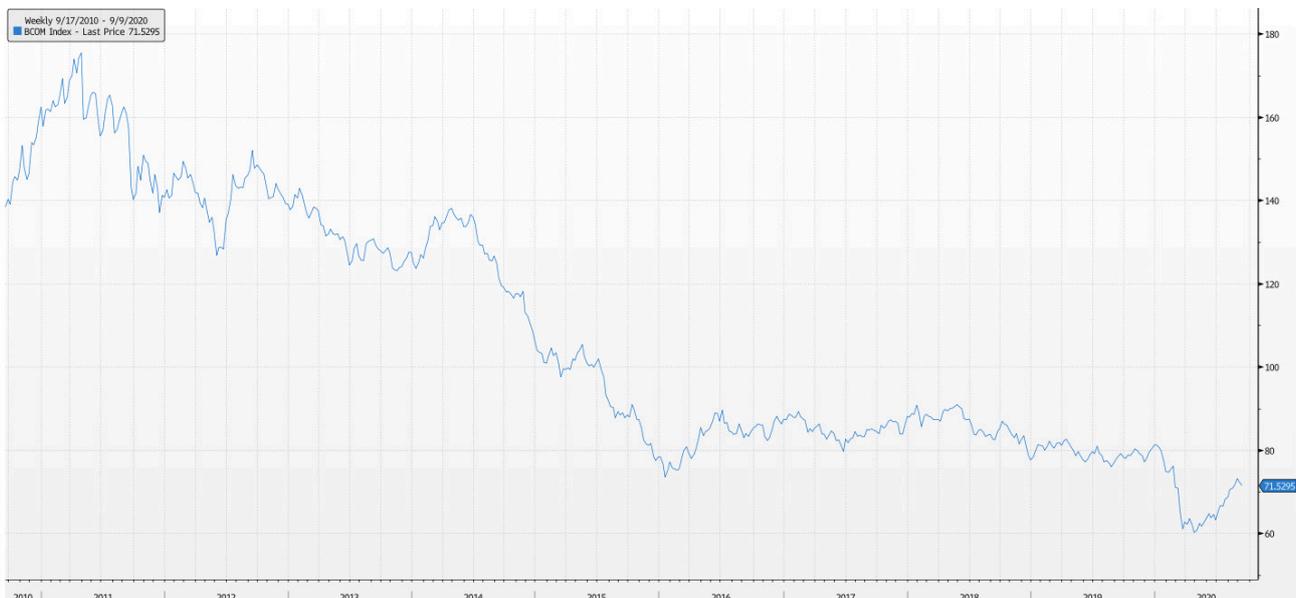
As we’ll examine in greater detail in this analysis, all four commodity types we’ll look at appear to have strong drivers in place that support a very optimistic outlook for the months and years to come. These sectors, namely agriculture, base metals, energy and precious metals, differ in their nature and there are forces that are unique and specific to each one.

However, there are certain common denominators that largely underlie commodities as a whole.

First of all, the “lower-for-longer” price environment has brought about significant underinvestment in most commodity sectors. While capital expenditure in general has seen a steep and steady decline over the last decade, this has particularly impacted metals and energy, as the underinvestment in mining and exploration projects has been especially pronounced. In the commodity sector, a highly cyclical one, there is an age-old adage that still holds true: “the cure for low prices is low prices”, meaning that weak prices lead to underinvestment, which leads to supply contraction, which eventually leads to higher prices. Contrary to many other sectors, i.e. technology or industrials, in the commodity sector, it may take years to increase the supply, leaving demand unmatched for much longer and thereby pushing and keeping prices higher for a long time.

Secondly, inflation expectations have been substantially increased since the onset of the covid crisis, as a result of the monetary and fiscal responses to it. These expectations were recently reinforced by

Commodity sector performance over the last decade, as measured by the Bloomberg Commodities Index (BCOM)



Source: Bloomberg

the landmark policy shift unveiled by the Federal Reserve, that will allow inflation to rise above the 2% target “for some time”, while keeping interest rates at ultra-low levels for the foreseeable future. This should provide a remarkable boost to commodities, as historically, there’s a significant positive correlation between consumer price inflation and commodity prices.

Last, but certainly not least, the fiscal policy landscape is looking increasingly supportive as well. The coronavirus relief packages have already marked an important sea change in policy direction, which is expected to persist and likely intensify, as the damage caused by the lockdowns and the shutdowns continues to pose a serious threat to the global economy. This aggressive spending approach is likely to provide support in particular for the energy sector and for base metals. Specific metals like copper and nickel are bound to benefit the most, as they are also very well positioned in regards to the wider trend toward “green” energy and renewables.

Agriculture

Overall, the last decade was challenging for agricultural commodities, a sector that is extremely diverse

and notoriously volatile even during the best of times. As measured by the Bloomberg Agriculture Subindex (BCOMAG), agricultural commodity prices have been on a steep long-term downtrend since 2011 and have only risen in one year out of the last seven. However, a few months ago, the index began to show early signs of a possible reversal on the way.

The covid shock had a severe impact on soft commodities like cocoa and coffee, but that was very quickly replaced by a strong rally, buoyed by weather concerns and a weaker dollar. More recently, grains have seen impressive price gains, as China boosted its imports of U.S. crops, something that is expected to continue, despite the trade tensions, as part of the “phase one” trade deal.

As general rule, it is ill-advised to make blanket statements and predictions for agricultural commodities as whole. The sector encompasses a very wide range of commodities, each representing a market with particular and often unique drivers, ranging from specific weather conditions, to geopolitics and local regulatory changes. Looking at the bigger picture, however, what we can safely say is that agricultural commodities do stand to benefit from the emerging inflation theme and this supports the sector’s mid-

Bloomberg Agriculture Subindex (BCOMAG), 2010-2020



Source: Bloomberg

and long-term outlook. Additional support is found in global demographic trends. The growing world population, expected to hit 9.7 billion by 2050, according to UN projections, and more specifically, the growing global middle class, combined with a strong urbanization trend, present challenges to the future of global food production and supply. This is already evident in China. As reported by Reuters, a recent report by a Chinese government think tank sounded the alarm over a food supply gap by 2025, as “within five years, the proportion of the population living in urban areas is expected to hit 65.5 percent of China’s total, up from 60.6 percent by the end of last year, with around 80 million rural residents moving into the cities”.

The purest way to gain exposure to agricultural commodities would be through a commodity ETF tracking the entire sector, which would limit the impact of the various idiosyncrasies of individual commodities and their short-term volatility that can be at times extreme. As there are many pitfalls associated with futures-based commodities, investors should be very careful.

Energy

While the first half of 2020 was particularly disastrous for oil and gas causing many analysts to declare an absolute bottom in the sector, it came after many consistently challenging years. Historically weak prices have translated into chronic underinvestment, which was further exacerbated by the record price lows brought about by the covid crisis. According to the International Energy Agency’s latest projections, capital spending in the oil and gas sector is set to fall by one-third in 2020, highlighting that “pre-crisis expectations of modest growth have turned into the largest fall in global energy investment on record”.

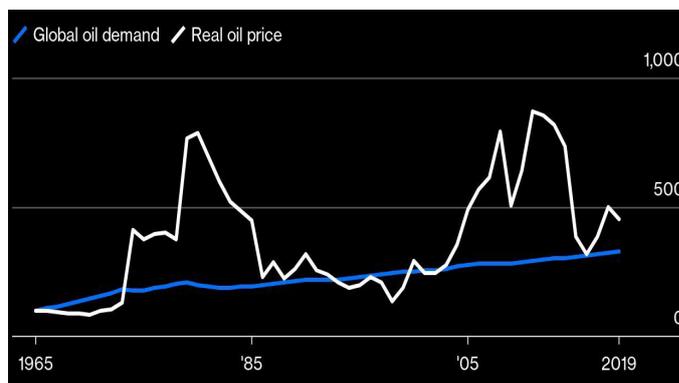
Given the multi-year lead time of new oil and gas projects and the scale of these expenditure cuts, it is very likely that the resulting slump in supply will be significantly disproportional to the demand shock caused by the pandemic. Should demand pick up faster and stronger than initially expected, for which there are some solid indicators out of China that has already recovered more than 90% of its pre-crisis

demand levels, we could see prices surge. This is further supported by the fact that investment trends were already poorly aligned with the projected global demand, even before the covid crisis.

There are, of course, additional drivers that support the case for a strong reversal over the coming months and years. The covid shock may have wreaked havoc in the energy sector in many ways, but the extreme pressures it introduced also forced some important changes and re-evaluations, especially in the U.S. shale oil business. Many companies that have been in dire financial straits for years, saddled with dangerously high levels of debt, may have found this crisis to be a blessing in disguise. These companies face the necessity to bring down costs, resort to mass layoffs, cut dividends and management compensation, to write off or sell unproductive assets.

This situation can help them emerge leaner and stronger from this crisis and with a healthier balance sheet. A recent example of this was Whiting Petroleum, which exited Chapter 11 bankruptcy in early September. The company was among the first major oil producers to file for bankruptcy protection back in April, and now its restructuring plan allowed it to lower its debt by approximately \$3 billion, while it also cut a third of its workforce and proceeded with key management changes. Nevertheless, investors should still be cautious, as for other companies, any help might come too late to save them from bankruptcy.

The oil market can be volatile, but the broad demand trend moves steadily upward



Source: Bloomberg

Finally, it is crucial to understand the dynamics on the demand side. A lot has been said and written over the last years about the switch to “green” energy and all the activist efforts to either aggressively reform or topple the oil and gas sector. Although many countries have made pledges and took some early steps towards various sustainability goals, the fact of the matter is that oil and gas demand is expected to remain stable in OECD countries at least for the next decade. In fact, according to OPEC estimates, demand is even expected to rise in the mid- and long-term in markets like India and China, “driven by an expanding middle class, high population growth rates and stronger economic growth potential”. For natural gas, the global demand outlook is even more positive. It has already been rising steadily over the last decades and it is projected to climb even higher, as it is seen a cleaner alternative to replace existing coal plants and used in new power plants to add clean, reliable energy to the overall energy mix.

The investment implications are therefore quite clear. The energy sector at large shows promising potential and there are numerous buying opportunities to be found at price levels that were rendered even more attractive by the covid shock. ETFs can provide exposure to oil and gas prices, as well as to producers, oilfield service providers and other relevant companies. Investing in individual stocks can also prove very profitable, but it does come with higher levels of risk. Given the debt levels and the additional pressures exerted by the pandemic, we see it as essential to have a very detailed and careful screening process in place to identify those companies with healthier balance sheets.

Base metals

The base metals sector has also been plagued by low prices and years of underinvestment and it now presents some very interesting investment opportunities. Copper and nickel are the most prominent among them, as there are very strong supportive forces at play in both cases.

The “traditional” demand driver for nickel is the stainless steel industry, accounting for over 70% of nickel demand. Nickel is the essential ingredient

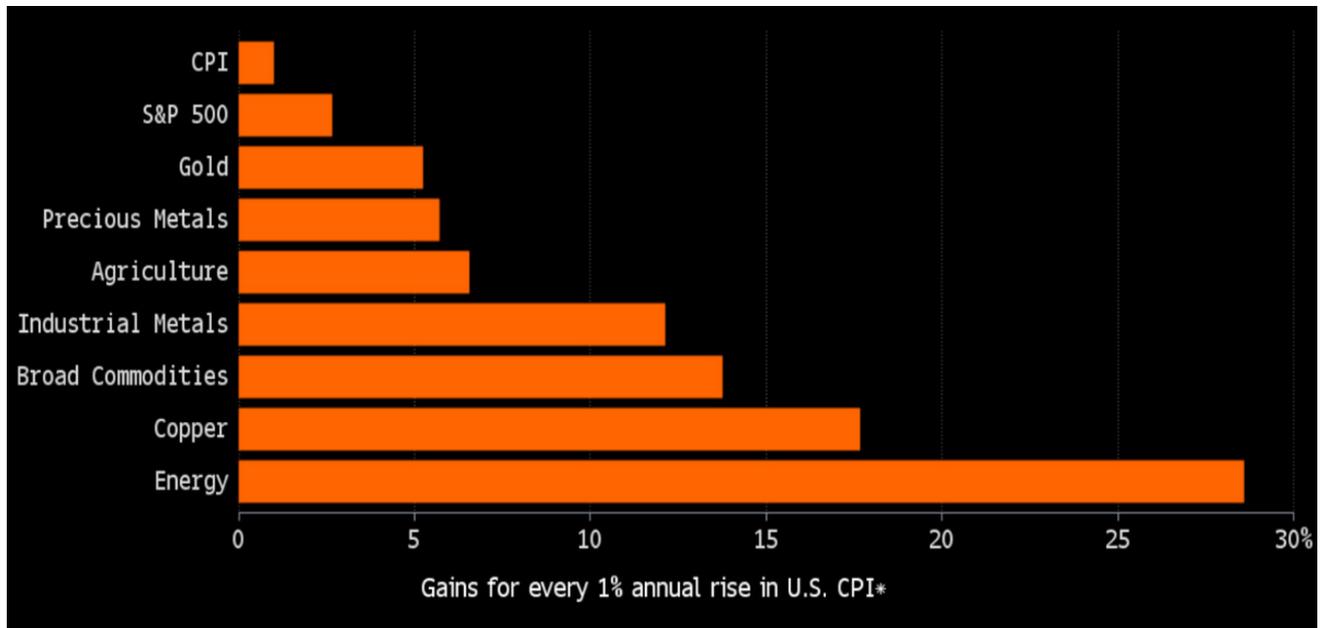
that makes stainless steel highly corrosion resistant and thus its price fluctuations are closely correlated with the infrastructure and construction industries, the major consumers of stainless steel. In this regard, economic activity in China plays a key role in determining the direction of the nickel price. The country’s stainless steel output accounts for approximately 50% of global production, and it is expected to keep growing, albeit at a slower rate of 3.4% in 2020, compared to the 9.4% year on year increase in 2019.

There is also another important demand driver, namely the rapidly growing electric vehicle (EV) industry. Nickel is heavily used in EV batteries and the global move towards automobile electrification, driven by government incentives, companies and individual consumers, did slow down by the pandemic, but it already shows signs of a strong comeback. Currently, the EV batteries’ share of global nickel demand stands at only 4%, but as EV sales climb, it is projected to reach nearly 10% of the total in 2022 and 20% by 2030, according commodity research firm Roskill.

The case for copper could be even stronger, as a growing number of analysts concur that the red metal has the best long-term prospects in the base metals sector. As an S&P Global Market Intelligence report put it, copper is just emerging from a “dismal decade” of massive underinvestment. As the report highlighted, 224 major copper discoveries were made since 1990, but only 16 of those were in the past decade and there has been only one major discovery since 2015. As a result, while there are enough reserves to meet immediate demand, the production cuts of last decade are likely to cause a supply crunch in the years to come.

Often dubbed “Dr. Copper”, the red metal is widely acknowledged an indicator of economic health. As such, to a very large extent, copper’s demand prospects are tied to the pace and the scale of the recovery from the covid crisis. Copper is omnipresent as a core component in electrical equipment, wiring and piping, telecommunications, construction and industrial machinery, therefore the macro environment, the revival of the manufacturing

As inflation heats up, historically copper tends to rise three times more than gold



Source: Bloomberg

sector, and infrastructure, play a considerable role in price direction. Indeed, the metal rose to a 2-year high in early September, as investors welcomed improving manufacturing data, especially out of China, a key source of copper demand. In addition to this, in recent years, the metal has also seen increased demand due to advances in “green” technologies and renewables, as it is heavily used in solar, hydro, thermal and wind energy systems.

Finally, copper is also an excellent inflation hedge, because of its extensive uses and its instrumental role in manufacturing, industrial production and end consumer goods. Naturally, as the price of goods and services rises, so does the price of the commodities used to produce them. In fact, copper has a better track record as an inflation hedge than gold, which is the ultimate crisis hedge.

ETFs can provide very good exposure to copper and nickel, as would single miner stocks. In the latter case, much like with oil and gas, caution is necessary in the screening process to ensure the selection of high-quality stocks.

Precious metals

As we outlined in our previous issues of the InSights, the investment case for gold and silver is very strong. The fiscal and monetary responses to the covid crisis have already paved the way for the return of inflation, and not just for asset price inflation, but also for consumer price inflation. Now, as it becomes clear that the economic damage is here to stay and as governments start to prepare for a “second wave” of relief packages and massive spending, the outlook for precious metals appears even brighter.

However, it’s not just inflation that precious metals can provide protection from. Especially gold is a solid hedge against different risks that are on the forefront of many investors’ minds. The currency crises currently underway in Turkey and Lebanon, the sovereign debt crises in Argentina and Ecuador, are arguably just the tip of the iceberg. Given the scale of lockdown damage and the decades of excessive debt accumulation that preceded it, there are many more countries that could find themselves in a financial dead-end. According to Fitch Ratings, sovereign

defaults are set to hit a record this year, as in only the first four months of 2020 there were a record 29 sovereign downgrades.

The overall climate of uncertainty, the heightened volatility and the stretched valuations in equity markets are also driving investors to seek refuge in precious metals. This is increasingly true for retail investors and ordinary savers too, many of whom never owned any financial assets before. A recent survey by LendingTree revealed that one in six Americans bought gold or other precious metals in the last three months. On Robinhood, the popular mobile trading app for amateur investors, the number of users holding two of its largest gold funds has tripled since the start of the year.

Conclusions

As we enter fall, concerns over a new wave of covid infections are on the rise and so are fears of further lockdowns and restrictions on economic activity. On the other hand, fresh stimulus packages are also in the pipeline, as fiscal and monetary support is here to stay. For investors, it is certainly a time of widespread uncertainty and great volatility, but the forces that are likely to drive commodities are already in place and set to intensify over the coming months and years.

For instance, we might not know yet exactly what form the new fiscal relief efforts will take in major economies, whether there will more “covid checks” or an introduction of the Universal Basic Income, a trial launch of which we recently saw in Germany, but we do know further stimulus is on the way and it is likely to break new government spending and borrowing records. More monetary easing is also all but guaranteed and so are “lower for longer” interest rates, thereby solidifying inflation expectations which are set to benefit commodities at large. What is also highly probable is that the shift towards the “green” economy will continue and likely accelerate, since much of the stimulus, the grants and the loans, are tied to the green agenda, as we saw in the case of the Eurozone recovery deal.

Overall, we feel that the previous decade of severe challenges and widespread underinvestment has created many opportunities in commodity sectors that are especially attractive at the current price levels. However, although our commodities outlook is very positive, we must highlight the need for investors to be cautious and to employ a very careful screening process when evaluating individual stocks. There are indeed great bargains to be found in commodities and there are companies that will emerge stronger from this crisis, but there are also those that will not emerge at all. Therefore, it is essential to mitigate these risks by identifying high quality companies, with healthy balance sheets and a solid track record.



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