CARMIGNAC – H1 2024 OUTLOOK

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OVERVIEW

- The global economy should continue to prove resilient to the real rate shock in H1 2024 but the buffers will tire out in the second half of the year, as recession finally hits.
- Financial markets are all the more oblivious to the underlying cyclical risk as the post-Covid re-leveraging occurred in a 'barbelled' form between government borrowing and opaque private debt channels.
- Immigration and resilient asset prices (housing, equities) are key mainstays of the soft landing so far. But they will be exploited by populist politicians to hasten the implementation of inflationary policies once the recession sets in.
- In China, staggered rounds of fiscal stimulus and liquidity injections should suffice to stabilize growth in H1, but this gradualism cannot defeat the risk of debt deflation. A holistic resolution of the debt overhang is needed, but resisted for political reasons.
- Selecting the right maturities in the government bond market is as important as predicting market direction due to the tug of war between peak policy rates and the return of price discovery mechanism.
- Credit markets will keep their number one position in terms of risk-adjusted returns, but macroeconomic headwinds in H2 will make bond picking even more crucial.
- The diversification of equity performance drivers is anticipated, requiring more detailed factor allocation in portfolio construction. Earnings growth is a strong driver of equity returns, but volatility of those earnings will also matter.
- Emerging markets are suitable candidates to express diversification, with the help of a lower US dollar and the stabilization of China's economy.

ECONOMY IN FOCUS – RAPHAËL GALLARDO, CHIEF ECONOMIST

“Developed economies have proved remarkably resilient to the sharp rise in real rates since 2022 (which should culminate with a normalization of rates in Japan in 2024). However, we do not believe in the "higher forever" neutral rate view.
Rather, the transmission of the rate shock to economies has been slowed by transitory factors that will be exhausted in the course of 2024. A "slow landing" should thus continue in H1 '24, followed by a recession in H2, led by the US.”

“In the US and Europe, the recessive process is driven mainly by profit-margin compression and is already visible in the rise in permanent job losses as well as in corporate and household defaults. However, its kinetic has been hampered by exogenous factors. On the corporate side, margins have been protected by excess cash and a pick-up in immigration that provides a workforce buffer. On the household side, savings rates are kept artificially low by excess cash and wealth effects from QE-distorted asset valuations.”

“Financial markets are all the more oblivious to the underlying cyclical risk as the post-Covid re-leveraging occurred in a 'barbelled' form between government borrowing and opaque private debt channels. This bifurcation increased resilience in the early phase of the slowdown, but will hinder policy flexibility and balance-sheet clean-ups once the recession hits.”

“Rising immigration and compressed financial risk premiums played their part in achieving a soft landing so far, but they have amplified the unaffordability crisis in housing, stoked wealth inequality and identity politics – all grievances that should play to the benefit of populist ideas in the current electoral cycle (e.g. Trump, Wilders). This will hasten the implementation of inflationary policies in response to the looming recession (fiscal largesse, protectionism, border closures).”

“In China, the unresolved housing crisis will keep foreign and domestic private-sector confidence at depressed levels. The latest stimulus package and the geopolitical détente with the US should suffice to stabilize growth around 4% in H1 2024. A reacceleration in H2 2024 requires the leadership to abandon its gradualist approach for a strategy combining a restructuring of all housing-related debts (including those of local government and LGFV[1]), nationalization of losses, bank recapitalization and consumption stimulus. Such a policy ‘quantum leap’ remains elusive for political reasons.”

INVESTMENT STRATEGY – KEVIN THOZET, MEMBER OF THE INVESTMENT COMMITTEE

“The slow landing of the economy over the first half of 2024 and mounting recessionary concerns as the year advances require active managers to be able to swiftly reallocate their portfolios; for others it means building asymmetric portfolios.”

“The expectation of 4% policy rates for the foreseeable future is at odds with a slower economy and cyclical disinflation. In **government bonds**, to navigate this dichotomy, one can build a long duration position while simultaneously avoiding betting on the timing of future rate cuts and being overly exposed to term-premium uncertainty.”

“Indeed markets are quite optimistic in expecting rates cuts to materialise as soon as the Spring, putting short-term maturities at risk. Further, the trajectory of long-term yields is dependent on debt to finance the deficit but this can’t be indefinitely absorbed by money markets in a world where there seems to be little appetite outside of the US to buy those long-term bonds. As a result, five-year maturities appear particularly attractive. And in the euro area, core rates are expected to trade lower given the anaemic growth environment.”

“The slow-motion slowdown, culminating in a recession in H2, implies that **credit markets** will retain their top spot in terms of risk-adjusted returns over the coming quarters. Credit not only offers very attractive carry but this in turn allows for the digestion of downward surprises. In this economic environment, favoured sectors (financials, energy and structured credit) where issuers that are accustomed to a high cost of capital given the exit from the “free money” era. As the year advances investors will have to be either willing to accept some volatility or able to protect their portfolio against mounting risk aversion.”

“In **equities** after a wild run by the Magnificent 7[2], conditions are in place for the broadening of performance drivers. Concentrated returns require some form of wariness and implementing a barbell approach to diversify from the most favoured names makes sense. This means allocation to defensive sectors via healthcare and staples on one hand and some higher return potential via emerging markets on the other.”

“**Emerging markets** are indeed suitable to express such a strive for diversification, with the help of a lower US dollar and the expected stabilization of China’s economy over the coming quarters. Opportunities may arise in previously sold-off markets like Asia or Latin America where trade balances are well oriented.”

[1]Local Government Financing Vehicle.

[2]Apple, Amazon, Alphabet, Nvidia, Meta, Microsoft and Tesla.