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CARMIGNAC – H1 2025 OUTLOOK

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WHO'S AFRAID OF THE BOND VIGILANTES?

- After the 'great election year', populism is back but fiscal reality will hit hard.
- Inflationary promises will be put to test by the bond markets – particularly in the US.
- In the eurozone, the threat of contagion from the current French political crisis overhangs and in China, political resistance to meaningful consumption stimulus will keep growth lacklustre.
- The return of bond vigilantes could see a regional rotation in portfolios, calling for diversification.
- In equities, we're seeing opportunities to re-engage with undervalued European names and 'Trump friends'.
- In fixed income, short-term investment grade, high-yield corporate debt and inflation-linked bonds appeal.

ECONOMIC PERSPECTIVES – RAPHAËL GALLARDO, CHIEF ECONOMIST

2024 was the 'great election year' with almost 40% of the world's population - representing 60% of global GDP - going to the polls. Although incumbent governments embraced some of the heterodox policies of their opponents, 80% of them were overthrown by the global populist wave. After three decades of rising inequalities and quasi-stagnation in real median wages, the return of inflation in 2021-2023 was the last straw that convinced voters to abandon the market-friendly orthodoxy embedded in the 'Washington Consensus'.

In 2025, populist leaders, elected on anti-inflation platforms, will face the test of fiscal realities: sticky inflation (a global phenomenon ex. China) and unsustainable fiscal paths will keep real borrowing costs elevated and FX markets extremely nervous. A reckoning awaits populists that will test the patience of so-called 'bond vigilantes', especially as all major central banks are shrinking their balance sheets, thus reducing the liquidity available to ensure smooth functioning of bond markets. Should these powerful investors start selling, in protest at seemingly unsustainable fiscal policies, a flood of bonds will drive up borrowing costs and weaken the FX rate, causing a negative feedback loop with inflation and the real economy.

The return of the 'populist-in-chief', Trump, will, almost certainly, lead to an immediate tightening of migration policies and imposition of tariffs, hampering the supply side of the US economy On the contrary, prospects of deregulation and tax cuts would boost domestic demand. This will keep the economy growing at around 2.5%, but with sticky inflation above target and elevated real borrowing rates, particularly for low-income households. This 'non-inclusive' growth will exacerbate the social frustrations that mobilised Trump's electoral coalition. Conscious of his political vulnerability in the House (razor-thin majority), Trump will feel compelled to deliver on his electoral promises of tax cuts and industrial renaissance. This is where he will face the constraint of a saturated bond market and a strong Nasdaq-driven dollar. The populist will then turn into a disruptor.

Like Franklin D. Roosevelt, Nixon and Reagan before him, Trump will be tempted to loosen the external and fiscal constraints and recreate some policy space by externalising the costs of adjustment to the rest of the world, via a fall in the dollar (Plaza II) or by imposing financial repression on his allies (issuing war bonds to his NATO+ allies). As a last resort, Trump could scuttle the Fed's independence.

As far as the eurozone is concerned, the main driver next year will be the political and fiscal trajectory of France. If the French political class is unable to reverse the fiscal deterioration, the institutional crisis could morph into a financial crisis with global ramifications, given the dissemination of French sovereign bonds in global portfolios and the large global footprint of French banks. More importantly, the current impasse sanctions 25 years of failure by the European Union to enforce fiscal discipline mechanisms on the euro area member states - a vital condition for a sustainable currency union. The ungovernability of the country means it cannot be bailed out, for now, by the safeguards created after the Greek crisis (ESM, OMT, TPI). Therefore, doubts on the sustainability of the euro construct could resurface. Unlike the United States, which is indebted in its own currency and can monetise its military might, France cannot deflate its debt or devalue its currency. The pain of the fiscal adjustment will be felt in the real economy, notably on the labour market.

Lastly, China already is on the verge of debt deflation, i.e. Japanification, but sticks to reactive de minimis stimulus policies, with an ideological refusal to implement policies that could stimulate consumer spending. The stabilisation of house prices in tier-one cities is insufficient to leverage home building activity at the national level. Xi's priority is to build a sanction-proof export-oriented economy on the technology frontier. The dystopian surveillance of the population enables it to increase the politically-acceptable level of social frustration. Absent tangible stimulus announced at the March parliamentary sessions, we will have to remain cautious about the Chinese economy.

INVESTMENT STRATEGY – KEVIN THOZET, MEMBER OF THE INVESTMENT COMMITTEE

Global markets have been quick to price further US exceptionalism following the election, while European and emerging market equities are stuck at the low end of their historical valuation ranges. The return of bond vigilantes, along with the US moving from exceptionalism to disruption, could be the catalysts for a great regional rotation. In this environment, we prefer:

Diversified and blended global equities

We anticipate the US to outperform at the beginning of the year (given the Trump 2.0 effect on consumer confidence and spending and companies with the highest effective tax rates (i.e. SMEs)). However, inflation concerns and a steeper yield curve down the line, could lead investors to question the truly exceptional US equity valuations. And in the rest of the world, one should not discard the potential of Chinese authorities to bring forward more easing, nor the capacity of European authorities to react at times of existential crisis.

As such, contrarian plays may take over as local policy makers are forced to react.

In the US, the base case scenario is foreign direct investment pouring into the market under the threat of tariffs. But we can't rule out others, such as a second Plaza accord, the issuance of 'Bessent Bonds' forced into client states to fiscal dominance.

In the meantime, the broadly shared pessimistic sentiment towards Europe means some great quality assets – less exposed to economic and political uncertainty - can be bought at discount compared to their American peers, providing a great portfolio diversifier.

We are not expecting fireworks in growth given what is happening – or rather not happening – on the old continent, but several factors could play in favour of European equities. There are many global leaders to be found at a very reasonable price. This is notably the case in sectors such as aerospace or electrification which are benefiting from long-term structural tailwinds and hence less dependent on economic growth. Here we find European and US companies which, despite having similar margins, expected earnings per share growth, and dollar based revenues, are trading at a 20% to 30% difference on numerous valuation metrics. Similar examples can be found in the consumer discretionary, pharmaceuticals and consumer staples sectors, where European companies with solid fundamentals and similar return on equity prospects have valuations which are miles apart from their US counterparts.

A selection of 'Trump friends'

In the rest of the world, a selection of 'Trump friends' also enables us to step foot in overlooked assets. We see opportunities in special-situation countries which have already had to battle with bond vigilantes and where significant reforms and turnaround policies are having an impact. Countries such as Argentina (where inflation is moving from triple to double digit), Turkey (where real yields are finally turning to positive territory), or Ecuador (where the combination of reforms and support from international institutions is beneficial). And also, in more well-covered countries such as Japan (where the strengthening currency and the tightening of monetary policy should be well perceived by both the president elect and global investors) and India (which enjoys positive long-term growth and a recent softening of equity valuations).

High carry and flexible fixed income

Given the soaring level of national debt and deficits globally, fiscal constraints mean non-US central banks are poised to do the 'economic' heavy lifting in 2025, rather than governments. This favours fixed income segments where foreseeable income ("carry") offers the best indicator of potential future returns over time and also the best cushion for digesting bad news. In this regard, we prefer short-term investment grade corporate bonds where a potential widening in credit spreads would be more than offset by the lowering of rates, and high-yield bonds with a favourable technical backdrop in a context where net issuances have been negative and are expected to be continuously met by investor appetite over the coming quarters.

We stay largely shy of the developed market sovereign bond space which, despite circumstances, offer a meagre yield.

Finally, the shape of the yield curve (inverted to flat) and the lingering inflation question leads us to prefer bonds linked to real rates (i.e. inflation-linked) over nominal ones.

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