A journey into uncharted territory

Author(s)
Didier Saint-Georges

Published
July 8, 2020

Length
7 minute(s) read

Investors are used to dealing with uncertainty – the very essence of financial markets – as they seek to anticipate what is necessarily an elusive future. However, these past six months have driven uncertainty into entirely uncharted territory, and in more ways than one. Rather than panicking, we feel we can and should rationally analyse what is occurring so as to grasp its full implications. That, after all, is what risk management is all about.

A brief review of financial market patterns

The overall trend in financial markets since the start of the year is hardly up for debate at this point. Equity markets initially responded to the extraordinarily potent economic shock caused by the Covid-19 lockdown measures, and subsequently to the unprecedented interventions by governments and central banks.

Market behaviour reflects the same underlying patterns we've been seeing for ten years

Governments attended to the bulk of the short-term financial distress engulfing the private sector, albeit at the cost of an additional hike to fiscal deficits. Meanwhile, central banks went to work creating as much money as needed to finance the surge in both public- and private-sector debt. Uncertainty will be rampant as this tour de force winds down, and the sense of a huge disconnect between financial markets and the real economy has rightly made many investors wary. That said, there is nothing really surprising about recent short-term market behaviour, as it reflects the same underlying patterns we've been seeing for ten years. Those patterns in turn rest on three main assumptions:

1) Weak real consumer demand in what are already badly battered economies heightens the secular deflationary trend and precludes any risk of consumer-price inflation. It follows that the deluge of central-bank liquidity won't cause any inflation other than that of financial asset-prices.

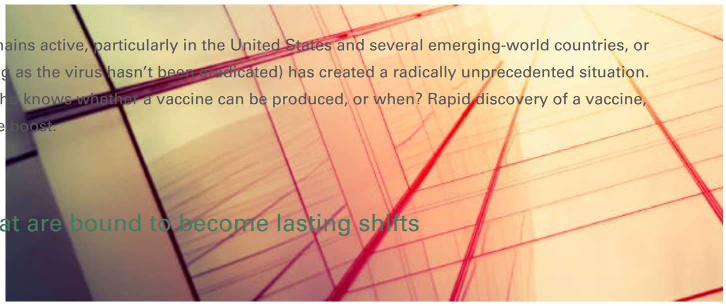
2) The ongoing uncertainty keeps central banks in a state of alert and suggests that they can be counted on to intervene promptly whenever required.

3) Prevalent investor scepticism is itself an obstacle to the formation of what would be a dangerously speculative bubble of the kind we have already witnessed in periods of excessive confidence. Investors are for the most part sticking to fairly cautious positioning, which helps support financial markets.

However, this short-term uncertainty – a factor that markets now handle with their eyes closed – is currently masking the emergence of other, much deeper forms of uncertainty. And though it may be too soon to eliminate them, we feel that this is a good time to start incorporating them into our thinking.

Public health – the first unknown

The first big unknown obviously pertains to public health. The fact that the pandemic remains active, particularly in the United States and several emerging-world countries, or may even be globally resurgent (little can be said today about possible new waves as long as the virus hasn't been eradicated) has created a radically unprecedented situation. Never before perhaps has a virus sparked so much research around the world, and yet who knows whether a vaccine can be produced, or when? Rapid discovery of a vaccine, followed by large-scale production, would certainly give consumer confidence a welcome boost.



> Whole sectors of the economy will have to adapt to what are bound to become lasting shifts

But even supposing human genius swiftly and successfully comes up with an effective way of countering the threat of infection, whole sectors of the economy will have to adapt to what are bound to become lasting shifts in how we work, communicate, stay informed, consume and get entertained. The process of adjusting to such far-reaching changes could lead to considerable recessionary pressures in specific industries (just think of conventional media, transport and mass leisure) – while at the same time spurring strong, profitable growth in others (as reflected in the sharp rise in the e-commerce uptake rate and the sea change in how media content gets produced and consumed).

Such developments could in turn trigger highly unsettling shock waves in yet other sectors like real estate, most notably commercial real estate. These factors are already shaping the sector and thematic positioning of our funds, and will continue to inform our thinking over the months to come.

The economy – the second unknown

The second major unknown has to do with the consequences of colossal fiscal deficits, which are driving up national debt at a time of extremely shaky economic growth. Moral hazard has risen to dizzying heights: if all you have to do to finance deficits is print money, then "everything is permitted", as Ivan Karamazov would have said. The current baseline scenario for investors is that the world economy is on the road to across-the-board "Japanification", consisting mainly of extremely low nominal growth rates combined with astronomical debt levels. What makes that combination possible are high savings rates and central-bank balance sheets overloaded with debt instruments issued by governments (and soon the private sector too). The assumption that interest rates will remain rock-bottom – a sine qua non for the survival of such an arrangement – is made credible by the historically large output gap between current economic output (severely crimped by the crisis) and the level of output we would experience if the economy were operating at its full potential. That output gap takes the risk of demand-fuelled inflation off the medium-term horizon.

However, the economic slump in the early portion of 2020 has produced another unprecedentedly huge and by no means harmless change: in response to these exceptional circumstances, the welfare state has made a stunning comeback. Moreover, it has done so just when the seeds of a counter-movement to the global free-market economy that took root in the 1980s were beginning to germinate. Not only are the demons of protectionism rearing their ugly heads, but public opinion in the United States and elsewhere is finding it increasingly hard to swallow the reality that, for decades now, the vast majority of the population has earned too little income to be able to build up precautionary savings, whereas the stock market is continuing to set record highs.

Mounting inequality – driven by rising prices for financial assets alone, not by rising wages – has become a source of growing rebellion in society. In the US presidential election this coming November, that rebellion could support an unapologetic commitment to state intervention, based on a strengthened public sector and much broader redistribution of society's wealth. In the process, it would also take the wind out of the sails of the right-wing populism that has let so many voters down. To be sure, with fiscal deficits shooting up in most major economies, a few voices (mainly from a minority of US Republicans and some Northern European governments) are calling for a return to fiscal orthodoxy. But they have to answer to critics who point to the disastrous economic consequences and social injustice produced by austerity policies. A combination of social pressure and a foreseeable spate of business failures over the coming months is likely to force governments to intervene further and on an increasingly large scale in the economy, pushing up fiscal deficits that central banks will inevitably have to monetise.

Those pressures certainly have their upside: to start with, they have compelled the European Union to close ranks. Once its leaders realised that no country is powerful enough to tackle on its own the daunting challenge of sustaining economic growth in such unsettled worldwide conditions, Germany fell into line. Those pressures could also sweep aside a good many misgivings about spending money on major infrastructure programmes, above all in the crucial area of preserving the environment. The imperative of European integration and the advent of large-scale socially responsible investing should thus be viewed as themes greatly favoured by current circumstances. We have incorporated those themes into our portfolio construction.

However, within a time span that is hard to estimate at this point, that outlook may hit a wall if investor confidence in those currencies that are being so lavishly handed out today ever wanes. In the zero-sum game of competition between currencies, it would be presumptuous to claim to know at this stage which one will win out. But in any event, the safe-haven status of the US dollar is fading with every passing day. This suggests that we will more likely need to manage our portfolios in a climate of general distrust towards all major currencies. We have accordingly maintained very little currency risk in our portfolios, and we also hold gold stocks to be able to deal with a limit-bound scenario for fiat money. If such a huge change in economic regime were to be accompanied by a perceived corresponding shift in the inflation regime – and however remote that eventuality may seem today – gold prices would also benefit from plummeting real interest rates.

Like any major trauma, the current public health crisis, which has since morphed into an economic crisis, is shining a merciless spotlight on existing fragilities. It is underscoring the value and necessity of robust risk management. And it is acting in many respects as a powerful accelerator of history. In today's rapidly changing climate, those companies best suited to the emerging dynamic will consolidate their lead. The challenge in the coming months will be to navigate what are almost sure to be unstable markets, while keeping an eye out for the winners of tomorrow.

Source: Carmignac, Bloomberg, 30/6/2020

Investment strategy

Equities

The tech sector and, more broadly speaking, secular growth stocks have continued to power equity markets and are sustaining the performance of our equity funds, which were already highly exposed to those sectors. The Covid-19 outbreak has shown clearly that such companies – particularly those related to digital technology – can keep expanding independently of global macroeconomic trends. That has earned them a growth premium. Furthermore, their profit structure gives them the kind of flexibility that is so crucial in the current period. They can swiftly increase their business volume without being compelled to raise additional capital – or, on the contrary, scale it back without being stuck with high fixed costs.

Another noteworthy feature of these past few weeks has been the substantial rally in European equities. That performance has been fuelled by the clearer economic outlook created by the appropriate, coordinated response from the European Commission, the European Central Bank and EU governments. We have accordingly upped our exposure to the region's equities by investing in high-quality cyclical stocks and banking index derivatives.

As we enter the second-quarter earnings season, financial markets appear to have already priced in part of the bad news. For that reason, we will be focusing as of now on 2021, a year for which investors seem to have high expectations (nearly on par with 2019). That calls in our view for careful stock selection and a cautious approach to portfolio construction.

Fixed income

Corporate credit and non-core eurozone sovereign bonds fared quite well in June. Europe's monetary and fiscal authorities have apparently been up to the challenge facing them, setting in motion an adequate, concurrent response – in the form of stimulus programmes announced by a growing number of countries and highly proactive central-bank policies. Fixed income markets are thus confronted today with two opposing forces that incline us to favour balanced portfolios. On the one hand, we may be heading for a deflationary period marked by rising corporate defaults – an outcome that has so far been postponed but not eliminated. On the other hand, unprecedented central-bank and government intervention could well revive the risk of inflation. With that in mind, we have opted for selective exposure to risk assets, primarily in corporate credit and Italian government paper. We have counterbalanced those investments with cash holdings and a portfolio of stocks likely to do well in times of slow growth.

Italy can look forward to a more promising outlook. First of all, the recent increase in the PEPP has cleared the decks for the ECB to absorb the entire net volume of Italian sovereign bond issuance between today and the end of the year. Second of all, now that banks have been offered the option of borrowing at –1% on TLTRO facilities, they will likely invest in sovereign bonds paying higher coupon rates. And last of all, a European recovery fund will almost inevitably come into being. These measures in combination should help normalise Italian credit spreads.

Three basic themes currently underpin our corporate credit portfolio: short-dated, mainly investment-grade paper; bank bonds; and bonds issued by companies that have taken a beating since the coronavirus outbreak.

Lastly, we plan to avoid broad-based exposure to emerging-market bonds until we have a better sense of where the US dollar is heading. We will be focusing rather on a few specific opportunities like Romanian and Mexican debt.

This is an advertising document. This article may not be reproduced, in whole or in part, without prior authorisation from the management company. It does not constitute a subscription offer, nor does it constitute investment advice. The information contained in this article may be partial information and may be modified without prior notice. Past performance is not necessarily indicative of future performance. Reference to certain securities and financial instruments is for illustrative purposes to highlight stocks that are or have been included in the portfolios of funds in the Carmignac range. This is not intended to promote direct investment in those instruments, nor does it constitute investment advice. The Management Company is not subject to prohibition on trading in these instruments prior to issuing any communication. The portfolios of Carmignac funds may change without previous notice. In the United Kingdom, this article was prepared by Carmignac Gestion, Carmignac Gestion Luxembourg or Carmignac UK Ltd and is being distributed in the UK by Carmignac Gestion Luxembourg.