SLEEPWALKERS

Mars 2016

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01.03.2016

We are protecting our high-conviction equity holdings in growth sectors from market risks.

As we expected, the markets have started to open their eyes to the unpleasant realities they face in 2016. Overconfidence in the US economy's resilience has faded a little, after the ISM manufacturing index dropped for the fourth month in a row in January. Investors' absolute faith in the abilities of central banks began to erode in January when the Bank of Japan introduced negative interest rates three weeks after ruling out such an approach, and the yen reacted by surging instead of falling.

The fall in bank share prices, which was perhaps slightly excessive in certain cases, reflected a late realisation of the collapse in the industry's earnings power due to negative interest rates and a heavy regulatory burden. Markets have been awakening. However, the complexity of the challenges faced does not yet seem to be fully acknowledged. Given the inanity of the final statement from the G20, which just finished meeting in Shanghai, it seems that central banks and governments, as well as many investors, are still sleepwalking ahead without appreciating the profound shift under way (see Carmignac's Note from July 2015 "The great transition has started").

We have therefore kept the strategic decision of a highly cautious stance that we adopted in September while seizing opportunities to buy cheaply whenever the markets overreact. Such opportunities have already arisen early this year, when we bought a selection of equities and corporate bonds in the energy sector, where we felt that prices reflected an overly pessimistic view of medium-term oil prices.

Regime change

As a reminder, the root of the problem lies in the extraordinary difficulty that any economy has in emerging from a major credit crisis. Japan experienced this after 1990. This time it has been affecting most developed and emerging countries since the great financial crisis of 2008. This was treated with radical cures (unprecedented monetary creation in the developed world, colossal investment plan financed with bank loans in China), which fizzled out, and leaves nowmostly iatrogenic effects (where the treatment itself becomes dangerous for the patient).

These negative consequences in the developed world are negative interest rates, bond bubbles, poor capital allocation and greater inequality, while in China they are industrial overcapacity and the deflationary pressures that it exerts, and a much weakened banking sector. By trying to eliminate economic cycles, central banks have created serious imbalances and have merely delayed the cycle. The main risk to the markets today is therefore the collision between the economic cycle, which is back with a vengeance, and the imbalances built up over the last seven years.

Central banks running their coursee

In theory, there is no real limit on the amount of financial assets that a central bank can buy (quantitative easing). Mario Draghi is trying to invoke this argument to discourage the markets from doubting his weaponry. In practice, though, every central bank has to wonder about the never-ending growth of its balance sheet and the imbalances that this widens at a time when lower and lower inflation expectations are showing how ineffective this approach is. The Fed has already started to normalise its monetary policy, while the BoJ and ECB are starting to use previously unthinkable negative interest rates to compensate for QE running out of steam.

However, these developments create new risks. Negative interest rates compound problems in the banking sector. And in the United States, the Fed's ambition to continue the monetary tightening cycle that began just three months ago is already on course for a full-on collision with the US economic slowdown. Further interest rate hikes may very well have to be ruled out for the near future, seriously undermining the confidence that investors have hitherto placed in the Fed. It goes without saying that a forced return to the QE abandoned in October 2014 would be the ultimate climb-down.

Economic slowdown

The markets finally seem to have seen through the illusion of a US economy suffering no more than a slowing of its oil and gas industry. The slowdown is clearly affecting manufacturing activity in general. However, the consensus appears to keep finding comfort in the belief that the legendary resilience of US consumers will allow them to escape the slowdown unscathed. In fact, a dwindling wealth effect as house-price inflation eases and stock indices fall will affect US consumers. Incidentally, the Conference Board consumer confidence index dropped much more sharply than most economists were expecting in February, with its "outlook" component in particular reaching a two-year low. Services expenditure has also started to slow. So, while the US economy may not quite slide into recession, we still believe the consensus is being overly optimistic about US growth in 2016.

The same complacency can be seen in Europe. In our opinion, the idea that the European economy will

continue to gather pace by virtue of a delayed cycle and highly supportive central bank is naive. IFO and ZEW confidence surveys, which are fairly reliable indicators of swings in the German economic cycle, turned down about six months ago, falling more steeply in February.

After growing by 1.45% last year, it is now highly unlikely that the Eurozone's powerhouse economy will reach anything like the 1.75% figure generally expected for 2016. This phenomenon applies to all Eurozone countries, to varying degrees.

There is now widespread recognition that China is still slowing. The lesser appreciated risk is that credit growth continues to outstrip economic growth by some distance, meaning that China's total leverage is still increasing. As usual, the lack of reliable data makes it hard to quantify the real situation in the country. However, according to our sources and after visiting China several times, our impression is that the stakes have continued to rise of late. In particular, the amount of capital outflows, the level of industrial production overcapacity, and the poor quality of balance sheets in the banking sector are all challenges to which the Chinese authorities might soon have to take a more radical approach alongside longer-term reforms. Whether this approach can avoid a much more accommodative monetary policy and a weaker currency seems highly unlikely, even if the timing of such developments cannot be determined.

The backdrop to this worrying situation, namely an overly leveraged economy particularly vulnerable to a lack of growth and inflation, along with greater political instability, only makes us more inclined to remain cautious. Risk management therefore remains our priority early this year. We are using our usual array of tools – index and sector hedges, US government bond positions, dollar and yen exposure – to protect our high-conviction equity holdings in growth sectors from immediate market risks.

Investment Strategy

Currencies

The key feature of the last two months has been the surge in the value of the Japanese yen, which has gained nearly 5% against the euro since the beginning of the year. This appreciation is part of investors' more general search for safe haven assets amid growing doubts about the impact of monetary policies on economic activity. Of particular note, the Bank of Japan's introduction of a negative interest rate policy could not curb the Japanese currency's ascent. The euro was highly volatile and has ultimately climbed only moderately against the US dollar since the beginning of the year despite various comments made by members of the ECB.

Our foreign exchange strategy, with a significant allocation to the yen, has therefore made a positive contribution to our funds' performance since the beginning of the year.

Fixed income

Although real inflation figures have picked up in the United States (largely due to the rising price of housing and medical services), inflation expectations as measured by 5-year/5-year forward inflation swaps have not stopped falling. This divergence creates a dilemma for the Fed as to whether it should continue tightening its monetary policy. The situation is clearer in Europe where both real and expected inflation are falling. **This suggests further intervention from the ECB to counter deflationary pressures.**

Our positions on sovereign bonds in Europe's periphery and United States have benefited from growing doubts about the rate of economic activity and central banks' ability to reach their inflation targets. The credit market has been more turbulent, especially in the high yield segment. **Our strategy here has been to take positions on high-quality corporate bonds and hedge our underlying market exposure so as to capture only the relative performance of our bond selection.**

Equities

The markets underwent a significant correction across all regions at the beginning of the year, with European equities among the worst performers. Concerns over the speed of the economic recovery became more widespread, especially in Europe, leading investors to question the very positive consensus early in the year. **Our defensive positioning with equity exposure close to its minimum permitted levels cushioned the impact on the Fund.** To strengthen our risk management at the beginning of the year we opened a small position in gold mining companies, which fully benefited from their safe haven status in February. **At the same time, we took advantage of investors' panic and resulting low prices to buy into groups hit by a wave of indiscriminate selling despite solid fundamentals.** Most of the companies that we identified were in the US energy sector, where we recently made selective investments in stocks such as Concho Resources and Hess Corporation to add to our position in Anadarko Petroleum.

Commodities

Carmignac Portfolio Commodities has been performing more or less in line with its reference indicator since the beginning of the year, despite huge volatility on commodity markets. We unwound some of our hedging in February to gradually increase the fund's level of exposure.

The oil and gas industry seems to have hit rock bottom, establishing the conditions needed for crude prices and oil stocks to rebound over the next 12 months. We hope to reap the benefits through positions taken where companies with the strongest fundamentals have fallen.

Funds of funds

Highly defensive positioning means that our funds of funds have significantly outperformed their respective reference indicators since the beginning of the year. Our portfolio’s focus on safe haven assets, and the yen in particular, has served our funds of funds well early this year.

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