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CARMIGNAC'S NOTE

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THE VIRUS AND THE RUBICON

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Most investors have grasped that the extraordinarily loose monetary policies pursued by the leading central banks in 2020 have provided greater support than ever for financial asset prices. So now that the worldwide Covid vaccination campaign has stirred hopes of economic recovery in a few months' time, the virtual guarantee that those policies will continue through 2021 and perhaps even beyond is extremely bullish news for equities.In financial markets, dovish monetary policies are boosting the uplift from vaccines.

This both explains and justifies the upbeat mood that has held sway for several months now. But it also brings to mind the observation that concluded our January 2020 Note: "… investors are still giddy from the market rally at the end of last year, and thus increasingly vulnerable…." No one could have predicted back then that a few weeks later an exogenous, public-health shock would underscore just how vulnerable they were. But we were still right to stick to a cautious stance, and it stood us in good stead when the market plummeted early in the year. Likewise, our prediction that an economic shutdown deliberately engineered by governments would trigger a shift to unprecedented fiscal and monetary stimulus policies enabled us to take advantage of the subsequent market rebound (see our April 2020 Note, "**Holding steady**").

> **"Though we remain fairly constructive in the short term, we're uncomfortable with the consensus among investors as the year gets under way"**

We're therefore uncomfortable with the broad consensus among investors as the new year gets under way. True, we remain fairly constructive on equities in the short term, as governments have stated their willingness to step up their support until the effect of mass vaccination has kicked in. But what is shaping our medium-term strategic thinking is that, while the Democrats have won an absolute majority in both houses of the US Congress on a platform of large-scale fiscal stimulus, that positive outlook is tempered by the imbalances that such a stimulus is likely to create. As we warned in our December Note, market developments in 2021 may prove to be trickier than is commonly thought.

Bumping up against reality

Financial markets have rightly hailed the announcement of the first vaccines in November and the current rollout process as the beginning of a new phase – one in which we can at last perceive the light at the end of the tunnel. Economists in turn have promptly forecast a long-awaited upswing for the second and third quarters of this year. According to their reasoning, the vaccination campaigns will by then have achieved critical mass, with the result that consumers will regain the confidence (and the permission) they need to satisfy their long-restrained wants, finally digging into the plentiful precautionary savings they have built up. That revival, we are told, will likely be accompanied by a stepped-up pace for the restocking already under way at companies. So the road to restoring freedom of movement for consumers and normal service activity seems open and clear.

The trouble is that the journey there isn't exactly going smoothly. From logistical challenges to vaccine hesitancy, and from the delicate job of managing priorities to varying degrees of success in the different countries, the return to normal somehow keeps receding from view. All those issues heighten the probability that taming the next wave of contagion will require further strict lockdown measures before mass vaccination can finally bring the pandemic under control. Moreover, the possible spread across Europe of a new, recently identified, much more contagious strain of the coronavirus is bound to increase the likelihood – and the duration – of yet another trying phase. While that eventuality doesn't necessarily spell danger for financial markets as long as governments and central banks continue to provide adequate support, it does suggest that we are right to stick with portfolios that have non-cyclical companies with predictable earnings growth as their backbone.

Towards a medium-term regime change for financial markets?

Maybe it's because 2021 marks the 50th anniversary of the end of the gold standard for the US dollar – a move that led swiftly to dollar depreciation and a surge in inflation (soon compounded by the first oil shock) – but in any case, with the US Senate now controlled by the Democrats, we can expect a most lively debate on the risk of inflation, which would be partly stoked by a weaker greenback. In fact, almost everything in the investment world today depends on the future of inflation. Interest rates immediately spring to mind, but the same can be said of equity valuations – not to mention the fate of the roughly $18 trillion worth of negative-yielding sovereign bonds. So the issue calls for careful examination.

Emboldened by the Democrats' newly-won control over both houses of Congress, the party's left wing will unquestionably demand the implementation of all the points in Joe Biden's campaign platform, including the most progressive ones. But it's worth recalling that the majority the Democrats gained by the skin of their teeth will be a touch-and-go affair, as no bills will pass without support from moderate lawmakers. This means that the more radical points in the new administration's programme are unlikely to be put into practice. We currently expect a new stimulus bill that will certainly be substantial, but still a far cry from a good many campaign promises. In addition, underemployment and excess industrial capacity still weigh heavily in the US, and population trends and technological disruption continue to exert a powerful long-term deflationary influence. We therefore believe that there is little risk of significant inflation in 2021 beyond a temporary base effect. Furthermore, though there is a reasonable consensus on a number of public-spending proposals, such as for infrastructure, the main tax increases on the table will probably meet with stiff opposition, particularly at a time of shaky GDP growth. Any increase in tax rates, particularly on capital gains and corporate earnings, will likely be mild and have only limited impact in 2021. Based on our estimates, GDP growth should bring the Federal budget deficit down from 16% to 10–11% in 2021 – a level that financial markets and the Fed should have little trouble financing. The chances are that the dollar will weaken further in 2021, but not to the point of buckling.

> **"The growing involvement of governments in the economy foreshadows a medium-term regime change for financial markets"**

This rather benign near-term outlook can't tell us much about long-term trends, however, because the fact remains that governments and central banks – particularly in the US – crossed the Rubicon in 2020. From here on in, it will be politically and socially quite hard to engineer a U-turn away from the government's growing involvement in the economy. A first indication of this is the simultaneous ballooning of fiscal deficits and the money supply. The shift to a Democratic majority in Congress could well mark the start of a sustained challenge to the economic model inaugurated forty years ago in the "Reagan-Thatcher" era – a model based on deregulation, lower taxes and a generally smaller role for government. The incoming US

Secretary of the Treasury, Janet Yellen, is an out-and-out Keynesian and makes no bones about it. This new philosophy on economic growth could well translate into policies geared openly to redistributing more of the country's wealth to wage- and salary-earners, and this more balanced distribution could reverse the current trends in productivity and inflation. Investors need to prepare for that, which is why we have taken positions in a few US cyclical sectors and in gold mining, and why we have established partial hedges on interest rates and the Nasdaq index.

Even so, a model that has been around for forty years deserves the benefit of the doubt, and economic uncertainty is the name of the game in the short run, notably in Europe. One last point should be highlighted. In 2020, one country bucked the dominant trend of forging blindly ahead. China has not only handled the pandemic quite well and avoided printing money galore; Beijing has also figured out (or was forced to figure out) how to "decouple" from the US. The Chinese market today is where a large share of our high-conviction investments are to be found. In our view, the overall balanced nature of our portfolios and our resolutely active approach to asset management should once again provide us with the means to generate performance in what promises to be a complicated year – and therefore one offering lots of opportunities.

Source : Carmignac, Bloomberg, 31/12/2020

Investment Strategy

Equities

2020 saw major disparities between world regions, with equity indices in China and the United States amply recovering to their pre-crisis levels while those in Europe still lagged behind. At the same time, even the abrupt price correction for value stocks at the close of the year wasn't enough to shift market leadership back from value to growth names.

That was the backdrop for the success of our international investment approach, which is based on reasonably priced secular growth stocks and flexible, timely investment decisions – enabling us to regain exposure last spring to the "re-opening of the economy" theme in targeted segments. The recent end-of-year euphoria has created more asymmetrical market risks, as a lot of the good news has already been priced in.

We are therefore entering 2021 with a moderately cautious approach to stock-picking and portfolio construction. We are maintaining our strategic preference for growth companies with predictable earnings appreciation so that we can take further advantage of the ongoing economic uncertainty, while keeping our eye on stock valuations. In order to reduce our portfolio's beta in a targeted manner, we have put in place a hedge on the Nasdaq. We have also taken profits on a number of stocks we consider more vulnerable to a market trend reversal; Chinese online platforms that will be facing greater regulatory risk are a prime example. We have likewise exited our positions in Chinese electric vehicle manufacturers in order to up our exposure to legacy carmakers in Europe and South Korea that are currently transitioning to electric vehicle production. To keep our portfolio balanced, we are maintaining our holdings in companies that stand to benefit from the re-opening of the economy. This includes new investments in sectors poised to cash in on an upswing recovery in US consumer spending. And as rising fiscal deficits are likely to support gold miners' share prices, we are holding onto our investments in them.

Fixed income

Good news on the vaccine front late in the year and the Fed's renewed commitment to leaving the volume of its asset purchases unchanged worked to the advantage of risk assets. The credit market bounced back to pre-crisis levels, while the yields on Portuguese and Spanish 10-year sovereigns slipped temporarily into negative territory. But while those developments are being underpinned by current and projected central-bank policies, the valuations on offer call for a more selective approach. We are accordingly buying bonds that in our view have the greatest potential for spread compression. In corporate credit, we will continue to favour issues in the energy, financial and tourism industries.

In government paper, we are maintaining our exposure to Italy, where bonds remain attractive in a period of financial repression and offer positive yields and a steep yield curve. Moreover, we expect net issuance by the Italian Treasury to be negative in 2021, given that the ECB will fully absorb the new issues.

The US central bank is focusing its intervention on short-term rates and, as a result, the upcoming economic recovery should mainly impact the long end of the yield curve. Though the fixed-income market has already priced in that recovery to a large extent, the prospect of an additional fiscal stimulus from the Biden administration has prompted us to short 10-year and 30-year US Treasuries.

Lastly, our exposure to the emerging world encompasses a number of currencies still lagging behind (e.g., the Korean won, the Chinese yuan and the Indian rupee) and a selection of debt instruments with good performance potential from countries like China and Romania.

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