Carmignac Sécurité: Letter from the Fund Manager

Author(s)

Marie-Anne Allier

Published

October 11, 2022

Len

+0.56%

Carmignac Sécurité's performance

in the 3rd quarter of 2022 for the A EUR Share class

-1.86%

Reference indicator's performance

in the 3rd quarter of 2022 for ICE BofA ML 1-3 years Euro All Government Index (EUR)

+2.42%

Outperformance of the Fund

over the quarter compared to the reference indicator

Carmignac Sécurité gained +0.55% in the third quarter of 2022, while its reference indicator[1] was down –1.86%.

The bond markets today

Bond markets have been posting record-breaking declines all year long, and the third quarter was no exception. Conditions even worsened in Q3, **making 2022 the bleakest year for sovereign bonds since the indices were first created. US Treasuries have lost 15% so far this year, the steepest fall since 1928, with long-dated maturities giving up nearly 35%.** That's even worse than this year's grim performance in stock markets. The downturn in fixed income was broad-based and affected all market segments; in Europe, aggregate corporate and sovereign bond indices ended the quarter off by over 15%. However, what we're actually experiencing is an abrupt normalisation after nearly 15 years of large-scale liquidity injections and negative interest rates. This marks the end of an era of financial repression and opens up attractive prospects for fixed income, with levels of carry that we haven't seen in over a decade.

The reasons for the abrupt normalisation in bond yields and credit spreads are the same as those outlined in our previous quarterly report:

- **Stubbornly high inflation, with the timing of peak inflation getting pushed back month after month.**This is giving rise to worries about knock-on effects. Consumer prices in Germany grew by 10.9% year over year in September, and those in the eurozone as a whole by 10%.
- **A faster pace of monetary tightening by central banks in response, in order to restore their credibility and prevent inflation expectations from becoming unanchored. That's in spite of the damage higher interest rates can cause to jobs and growth.** The trend of monetary policy tightening around the world marks a real shift away from the policy of the past 15 years and is something we haven't seen the likes of since the 1970s.
- The poorly targeted – and in any case probably not temporary – fiscal stimulus measures that governments have rolled out to help consumers cope with the higher cost of living. As we've seen in the UK, governments can lose their credibility quickly and with hefty consequences.
- **No respite in the war between Russia and Ukraine.**This is adding uncertainty, increasing inflationary pressure (e.g., through higher food and energy prices), and fuelling economic-growth worries as a result of embargos (on oil) and disruptions to the supply of natural gas, minerals, fertiliser, and more.

The ECB surprised investors and economists by raising interest rates faster than expected. Its 50 bp hike in July was followed by a 75 bp one in September, and President Lagarde seems determined to lift the policy rate to 2% by year-end. She probably won't stop there. Discussions have begun on the tricky task of shrinking the ECB's balance sheet, but it's likely that no steps will be taken before this December or next March. The yield on 10-year Bunds jumped by nearly 0.80% in Q3, a new record, and that on 2-year issues rose by over 1%. Italian credit spreads held up well after the ECB announced a new Transmission Protection Instrument. Even though recent elections gave the parliamentary majority to an extremely conservative (and previously Eurosceptic) right-wing coalition, the spreads on Italian paper widened by only around 30 bp.

Spreads on both high yield and investment grade corporate bonds ended the quarter close to where they began, but that masked significant swings during the period. Spreads initially narrowed as the broad rise in interest rates paused for breath. Then in mid-August, spreads once again widened – exceeding 6% on European high-yield debt and 2% on investment grade – as the stubborn inflation and tight job market prompted central banks to ramp up their monetary tightening, and the mini-budget debacle in the UK triggered a market dislocation.

Performance

Carmignac Sécurité generated a positive return in the third quarter despite the challenging climate and record losses in fixed-income markets. That helped to erase some of our underperformance relative to the reference indicator. Our short positions on core and peripheral bonds considerably mitigated the effects of the broad rise in interest rates. **But our main performance driver during the quarter (and for the months or even years to come) is clearly the carry on our portfolio, which includes an annual yield to maturity of more than 4% – a level we last achieved over a decade ago.** Our credit holdings added nearly 1 percentage point to our Q3 return strictly due to carry, notwithstanding the flat spreads over the period and the still-high cost of hedging in our portfolio. Our Q3 return was also lifted by our strategy to take advantage of rising inflation in Europe. Our residual exposure to Russia, which we don't want to offload at a price that's substantially lower than its potential recovery rate, doubled in value over the quarter (from 0.8% to 1.7% of the fund's assets). The average price of our bonds rose from around 20 cents on the dollar to 45–50 cents as liquidity returned to the market ahead of the unwinding of Russian CDS.

Positioning

We still believe that **central banks won't let their guard down just yet, given that inflation has proven to be stubborn and monetary policymakers are eager to restore their credibility. We will keep our portfolio positioned accordingly for the next few weeks.** But it's also true that the risk of a recession increases with each rate hike. A prolonged contraction now seems inevitable in Europe, which could face a harsh winter of energy restrictions and higher interest rates, and in the US, where Fed Chairman Jerome Powell seems keen to follow in Paul Volcker's footsteps in preventing inflation expectations from becoming unanchored.

We've kept our portfolio's modified duration low. It was 0.9 at end-September, up from 0.6 at end-June and a quarterly low of zero. **Our short positions are on German, French, Italian, and Spanish sovereign bonds, and all in the <10-year segment so as to benefit from a more marked flattening of the corresponding yield curves.** We've also shorted Japanese government debt, since its central bank is the only one that hasn't embarked on a tightening cycle. We're long on Australian paper (with no currency risk); the swift pace of monetary tightening in the country will have a direct impact on the domestic economy, since it's one of the most interest-rate sensitive and most exposed to property-market risk.

Our corporate holdings are still mainly in the financial and energy sectors and in CLOs, since we believe they'll gain the most from today's inflationary environment and climbing interest rates. Around 60% of our fund's assets are currently allocated to corporate paper, including 8.3% to CLOs and 9.5% to high-yield issues. We also have hedges on nearly 10% of our high-yield allocation through the iTraxx Crossover index.

Our portfolio's average yield to maturity was 4.5% at end-September, its highest in some 10 years. This elevated level will certainly be a key asset for our fund's performance going forward.

Carmignac Sécurité AW EUR Acc

ISIN: FR0010149120

Lower risk Higher risk

1	2*	3	4	5	6	7

Recommended minimum investment horizon

Main risks of the Fund

INTEREST RATE: Interest rate risk results in a decline in the net asset value in the event of changes in interest rates.

CREDIT: Credit risk is the risk that the issuer may default.

RISK OF CAPITAL LOSS: The portfolio does not guarantee or protect the capital invested. Capital loss occurs when a unit is sold at a lower price than that paid at the time of purchase.

CURRENCY: Currency risk is linked to exposure to a currency other than the Fund's valuation currency, either through direct investment or the use of forward financial instruments.

The Fund presents a risk of loss of capital.