MANAGEMENT REPORT – FIRST QUARTER OF 2018

Q1 2018

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Economic analysis

Although previously postponed by large-scale fiscal stimulus, the slowdown in the US economy now appears to be gaining traction. And with the Federal Reserve currently unwinding its balance sheet, that's no laughing matter. In fact, those two factors in combination – a faltering economy and a smaller central-bank balance sheet – may even breed enough anxiety to magnify the slowdown. This is clearly no time for complacency. On the other hand, the unfolding instability vindicates our active management style.

The global outlook

Three months ago, we wrote: *"The combination [in the US] of those fears with possible disappointment on economic growth will put the country on shaky ground at a time of ongoing monetary policy normalisation. And even if the reversal is limited in scope and the increase in inflation short-lived, they can be expected to occur concurrently in the next quarter – and therefore generate volatility."* With his frequent, exceedingly unconventional use of "diplomacy", the unpredictable Donald Trump is intensifying the renewed volatility we anticipated and increasing the likelihood of an economic downturn.

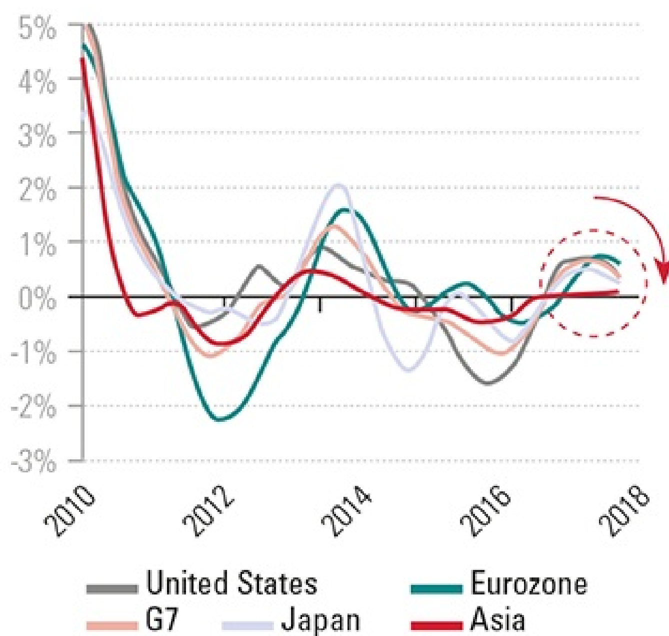
The signs of a cyclical reversal and faltering GDP growth in the United States were foreshadowed by similar signs in Europe. The euro's appreciation against all other currencies gradually seems to be undermining the bullish sentiment that the eurozone has so far enjoyed. In contrast, the emerging economies as a whole are reaping the benefits of a weak greenback and of the extremely slow pace at which US interest rates are rising. Those markets thus still have adequate cash.

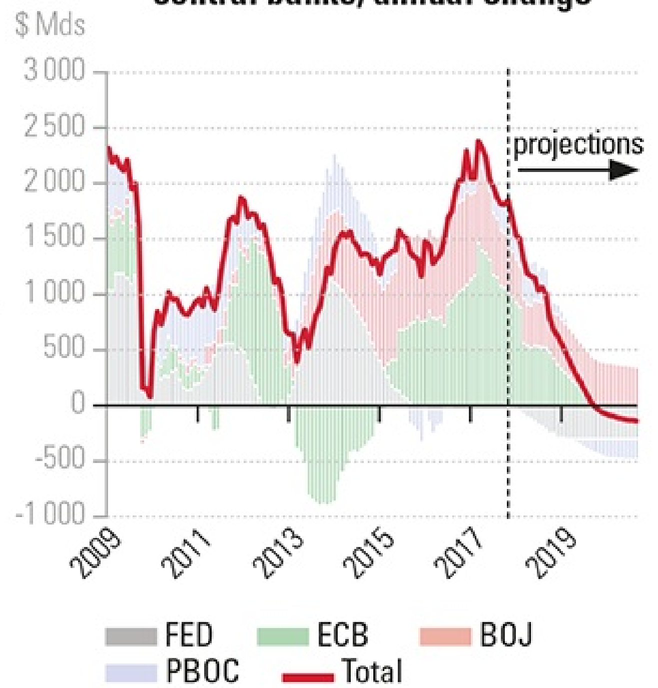
In our previous report, we asked: *"But will the current fairy-tale economy really be a never-ending story?"* The tale that got under way in 2009 in the United States, and more recently elsewhere, has taken us on several occasions down dark winding paths that eventually led to a confidence-inspiring clearing. The question is whether we are on such a side path right now.

Analysts are predicting 4.3% growth in the global economy over the next twelve months. That strikes us as a highly optimistic forecast, given how weak the leading economic indicators are on both sides of the Atlantic.

We maintain our view that the slowdown under way, coupled with a rebound in US inflation to 2.6% in July, makes a flexible approach to asset management the right choice in the near term. We also feel it would be unwise to make light of the possible threats to existing trade agreements and the tensions that could result, considering what a powerful driver of GDP and profit growth last year's pickup in world trade proved to be. A number of earlier certainties have begun to seem less convincing, thus paving the way for greater volatility.

A sea change for financial markets





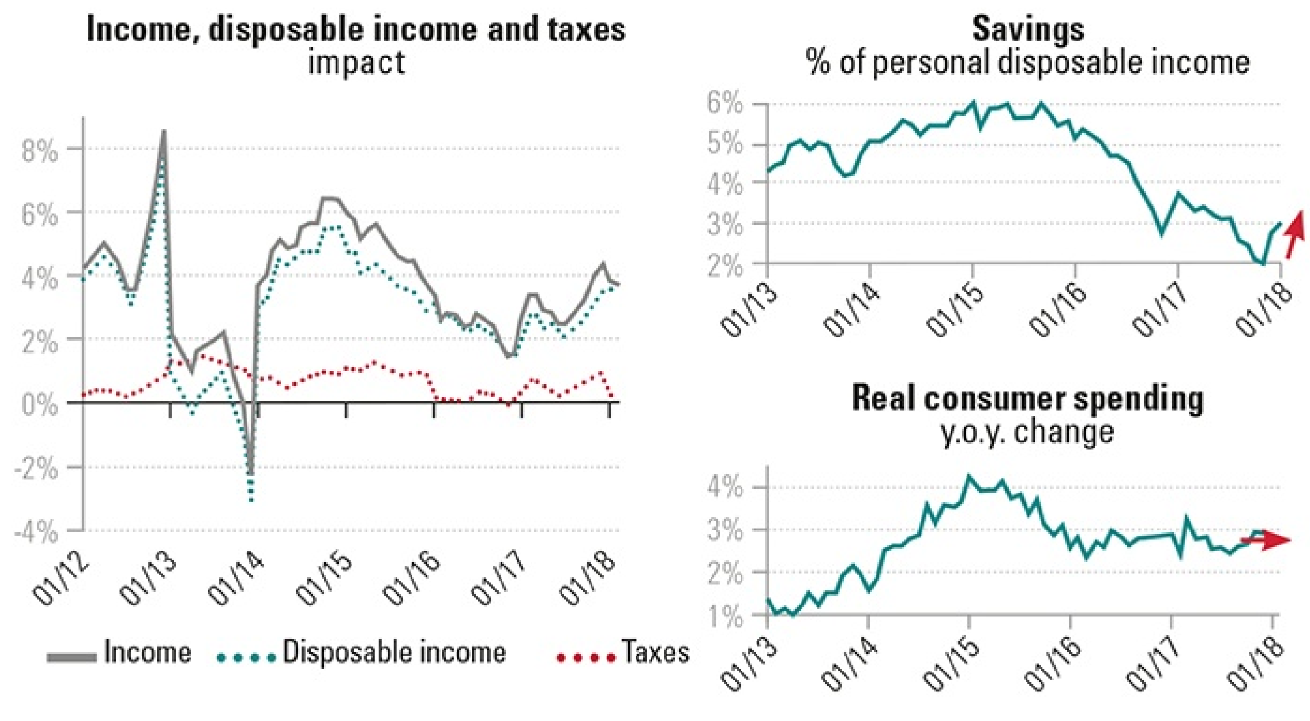
Sources:
Left: OCDE, Carmignac,02/2018
Right: Carmignac, CEIC, 03/2018

United States

Ever since the current US President was elected, one of the major mistakes made over and over by supposedly shrewd observers has been to underestimate his knack for shifting the course of events in the direction of his choosing. He won the election against all odds; he pushed through a major fiscal stimulus programme; he took action to remedy trade imbalances; and he delivered improvements in the lives of the electorate. From his struggle over trade relations with China to his battle against Amazon – including the e-commerce giant's business model and its founder, whom Trump deems an enemy – the President consistently acts out of electoral motives. We believe that his tweets are unlikely to have all that much impact. True, they increase volatility, but their main effect is to create noise. Such noise did play a role in the January market correction in the United States, with the internet heavyweights taking a beating. But that's

because, in addition to Trump's ranting and raving, those firms found themselves confronted with questions on tax avoidance and, above all, on their use of personal data – to a large extent the cornerstone of their business models. Sooner or later, monopolies always get caught out by anti-trust authorities or on tax grounds. But as that usually involves a lengthy process, we seriously doubt that the business models followed by the big names in the web economy are in any immediate danger.

A development deserving greater attention in our view is the mild economic slowdown under way in the US. Although previously postponed by large-scale fiscal stimulus, it now appears to be gaining traction and can be expected to have a long-term impact. The consensus forecast for US GDP growth in 2018 has been raised by 30 basis points, from 2.4% to 2.7%. Once again, we feel that the figure is too high, and for at least three reasons. The first one is that part of the increase in disposable income made possible by tax reform will go into savings, as the country now has an extremely low savings rate and a rather uncertain horizon. US households could well opt for building up precautionary savings, a trend observable since the beginning of the year, instead of spending all their additional income. With the ratio of household debt to disposable income at 105% – an all-time high – there's a very good chance they will. The consumer spending numbers point in any case in that direction. On an annualised basis, consumer spending is up by just 0.4% – despite a lighter tax burden and the bonuses granted by a number of key employers. The second reason is that the government's corporate investment incentives have yet to deliver the goods. The 3.5% increase in capacity utilization is still low, while per-unit profit margins have remained flat at 12%. And the third reason is that trade with the US's major partners is none too vigorous.



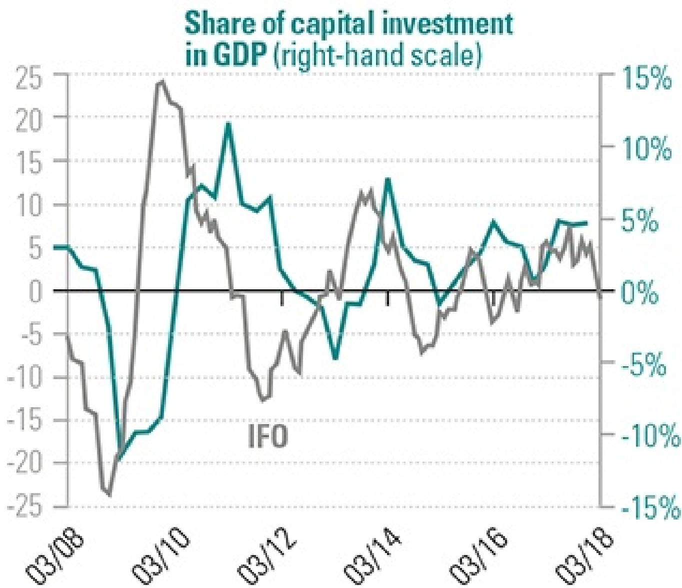
Source: Carmignac, CEIC, 02/2018

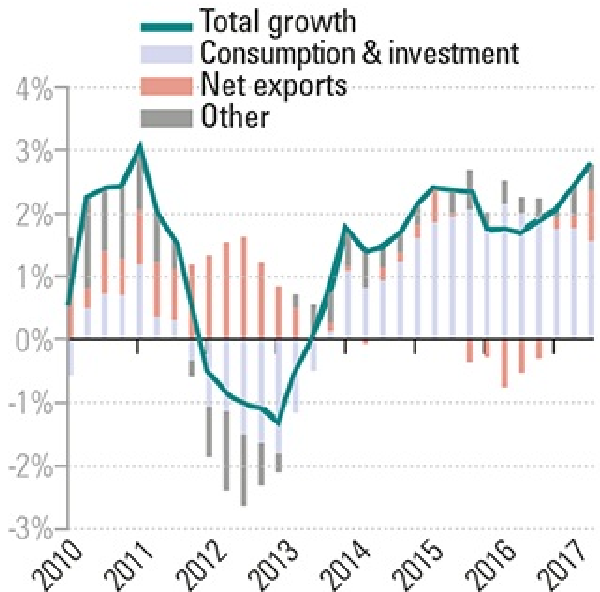
Now, weaker GDP growth just when the Federal Reserve is unwinding its balance sheet is clearly no laughing matter. In fact, those two factors in combination – a faltering economy and a smaller central-bank balance sheet – may even breed enough anxiety to magnify the slowdown. Jay Powell, the Fed's new Chairman, has recently voiced his awareness of that risk. He has pledged to slacken the pace of balance-sheet reduction and raise key rates more gradually than planned if inflationary pressure were to abate as expected starting in August. That suggests that the current slowdown may not be such bad news for equities after all. During the years of unconventional monetary policy (2008–2015), we saw repeatedly how stock markets responded positively whenever the economy stuttered, given that monetary policy could be expected almost automatically to come to the rescue. This is no time for complacency, however, because the tapering process is already under way.

Europe

In Europe, there are increasing signs of an economic slowdown as we predicted – if anything, sooner than we anticipated. The leading economic indicators for the eurozone, while still high, are sagging. The European Commission's Economic Sentiment Indicator slid from 115.3 in December 2017 to 112.6 in March 2018. Germany's IFO Business Climate Index fell from 111 in November to 104.4 recently, the biggest year-on-year decline in 15 months. Admittedly, seven months with no government in Germany, agitation by Catalan separatists in Spain and the weight of far-left and far-right parties in Italy have all taken their toll on confidence. To make matters worse, Donald Trump's aggressive economic policy calls for swift responses that a divided European Union is in no position to produce. But now that the US President aims to use the dollar as a weapon – by adding several hundred billion dollars to the Federal budget deficit – the eurozone's biggest handicap might well be the appreciation of its currency. International trade is already flagging, and the current account differential between Europe and the United States – a 3% surplus here and a 3% deficit there – will hardly be conducive to a weaker euro.

Europe: A cyclical economy highly dependent on global growth



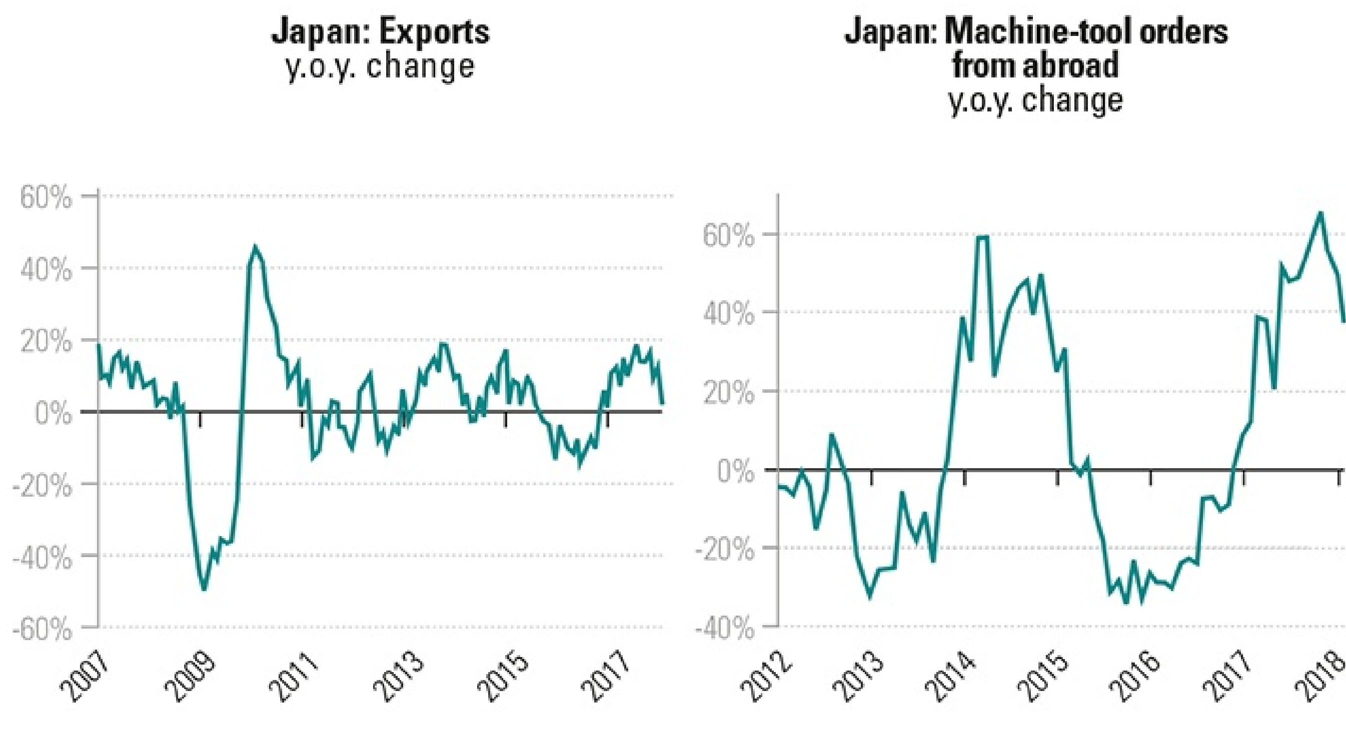


Sources:
Left: Carmignac, CEIC, 03/2018
Right: Carmignac, CEIC, 12/2017

Europe must therefore find a way to boost domestic growth. Will the German government, a reluctant convert to social-democracy if ever there was one, do its part by turning on the fiscal tap, as many have vainly hoped for so long? Growth in orders for durable goods in Germany fell from 9.5% in September 2017 to just 3.7% in February, and eurozone retail sales growth has been creeping along at an annual pace of just 1.8% – a 12-month low. Will those figures be enough to encourage the EU to take action to boost its own economy? Perhaps. But while it may feel good to fantasise about a continent powered by a more modern France and a less austerity-prone Germany, we would rather wait for tangible signs that we are actually heading in that direction. In any event, the European Central Bank has continued to provide sufficient support to encourage member states to adopt expansionary policies that will give their economies the strength they'll need going forward to withstand Mario Draghi's inevitable shift to normal monetary policy. With GDP growth in the eurozone currently exceeding 2% and inflation in the vicinity of 1.5%, a 0.5% yield on German 10-year government bonds is an anomaly for borrowers.

Emerging markets and Japan

In Japan as in Europe, the economic slowdown appears to be causing trouble even before it begins to bite in the US. And as both areas are highly vulnerable to the business cycle, their current woes substantiate our claim that global growth is decelerating. Japan's machine-tool orders from abroad fell by almost half over the past few months, while growth in the country's exports buckled from 18% in August 2017 to 1.8% in February, dragging down industrial output in the process.



Source: Carmignac, CEIC, 03/2018

Things look better in the emerging world, where a weak greenback and the Fed's policy of maintaining relatively low interest rates have helped keep those economies humming. China has continued to post high state-led growth (6.5%–7%) that doesn't seem to be detrimental to its trading partners. The country's least debatable statistics, such as electric power generation and rail freight, have rebounded sharply from the lows they hit in November and December 2017. The People's Republic is engaged in clamorous yet constructive trade negotiations with Washington that should cement its graduation to mature economy status as its trade flows become less asymmetrical. It also looks as if President Xi Jinping's long-range ambitions can more or less be squared with Donald Trump's short-term "America First" agenda.

India's economy is fortunately less affected than others by cyclical fluctuations. Meanwhile, Brazil and other leading raw materials producers are still riding the wave of global expansion even though it is heading for its peak, due to their late-cycle positioning. Finally, the sanctions imposed by the United States and Europe for what they consider Russia's provocations could do short-term damage to the Russian economy.

Investment strategy

The moderate economic slowdown we anticipated seems to be taking shape, but slightly later than expected due to the initial impact of US tax reform. The geographic areas most exposed to cyclical trends are in fact the ones currently showing the greatest weakness, thus supporting the argument that lower US taxes have delayed the deceleration in output. This slowdown – occurring in conjunction with a shrinking Federal Reserve balance sheet and with US government attacks on free trade standards and on the business model followed by digital economy powerhouses – has brought about a return to volatility. It thus vindicates an active approach to asset management designed to spot opportunities for both lucrative investment and wealth protection.

In the forex market, a rising Federal budget deficit, the sizeable current account differential between the US and Europe and the greater potential for monetary policy normalisation in the eurozone all point, as before, to a stronger euro against the dollar.

The expected ongoing appreciation of Europe's common currency will amplify the underperformance of a eurozone economy already hampered by institutional logjam and a mounting wave of disaffection with the European construction process. Those factors, combined with the continent's cyclical vulnerability at a time when the world economy is decelerating (however moderately), are likely to drive European equities down further – even after their recent swoon. Companies heavily reliant on exports will probably bear the brunt of that trend. We feel we should continue to favour US equities, which include the majority of today's high-growth companies with predictable earnings and most of the digital economy's leading firms – provided that the currency risk is adequately hedged. But as we foresee a weaker greenback and a limited increase in US bond yields, we also intend to remain overweight emerging-market stocks. Our equity portfolio is composed for the most part of companies that can increase their profits in a "scarce growth" environment and companies that stand to gain from a weaker dollar, including those in the energy sector. At the same time, we continue to short heavily indebted companies operating in cyclical industries.

Our view of the fixed income market is consistent with our view of the stock market. The flood of cash pumped into the market by the leading central banks led to such a large contraction in corporate credit spreads that we have reduced our exposure, especially now that issuance has resumed. In addition, because we now have less conviction regarding non-core European government bonds, we have taken profits on a sizeable share of our holdings. We are waiting for new political or valuation developments before returning to a theme that has contributed more than its fair share to our performance. Lastly, we expect yields on the main sovereign bonds to hold relatively steady in the weeks to come. As long as the ECB seems to be in so little of a hurry to normalise monetary policy, and as long as the slowdown in the United States mitigates the impact of tapering by the Fed, we believe that there is only limited room for a yield differential in either direction. Those conditions argue in favour of tactical but nonetheless profitable management of our fixed income holdings.

Source of data: Carmignac, CEIC, 29 March 2018

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