QUARTERLY REPORT

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MANAGEMENT REPORT – FOURTH QUARTER OF 2017

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Economic analysis

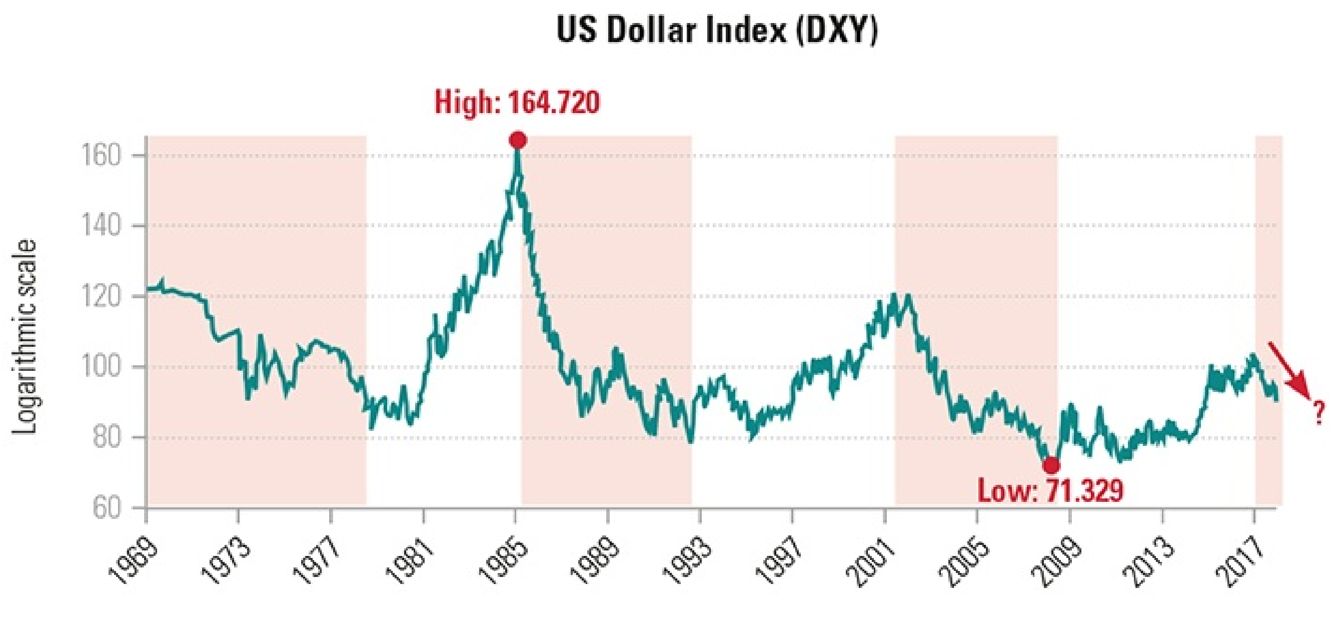
With the eurozone economy catching up, emerging markets still going strong, further abundant liquidity in the system and the recently passed US tax reform, stock markets have shot up to record highs. But will the current fairy-tale economy really be a never-ending story? Not only do we not believe the US economy will expand by as much as forecast, but we also think that the reversal we see coming, combined with a controlled slowdown in China, will lead to lower-than-expected-global growth accompanied by a mild uptick in inflation. 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.

The global outlook

Three months ago we wrote: *"Despite persistently weak inflation, central banks in the United States and Europe will soon initiate monetary policy normalisation, enabling them to manage down the amount of cash in the system. We feel that the Fed's growing perplexity over the absence of inflation bears out that view, but we are still keeping a watchful eye out for any pick-up in prices that the current business cycle might generate." Then we went to add: "... there are such powerful deflationary forces at work on both sides of the Atlantic that both central banks' inflation targets have become unattainable. And that makes the prospects of substantial hikes in their key rates seem highly unlikely"*.

Since our last quarterly report, the Federal Reserve has increased its benchmark interest rate once, without causing turmoil in the bond, equity or forex markets – at least as of year-end. Yields on US Treasuries have risen only slightly, while European sovereign yields have remained unchanged. At the same time, stock prices have continued to climb – impressively in the United States, Japan and the emerging markets, but less so in Europe due to the euro's appreciation. With the current economic climate buoying both the economy and financial markets, the Fed is continuing to scale back the reinvestment of proceeds from the bonds in its portfolio, the Bank of Japan has tapered its purchases of 10-year paper and the ECB is soon likely to start preparing the market for monetary policy normalisation. The macro balance is shifting right before our eyes.

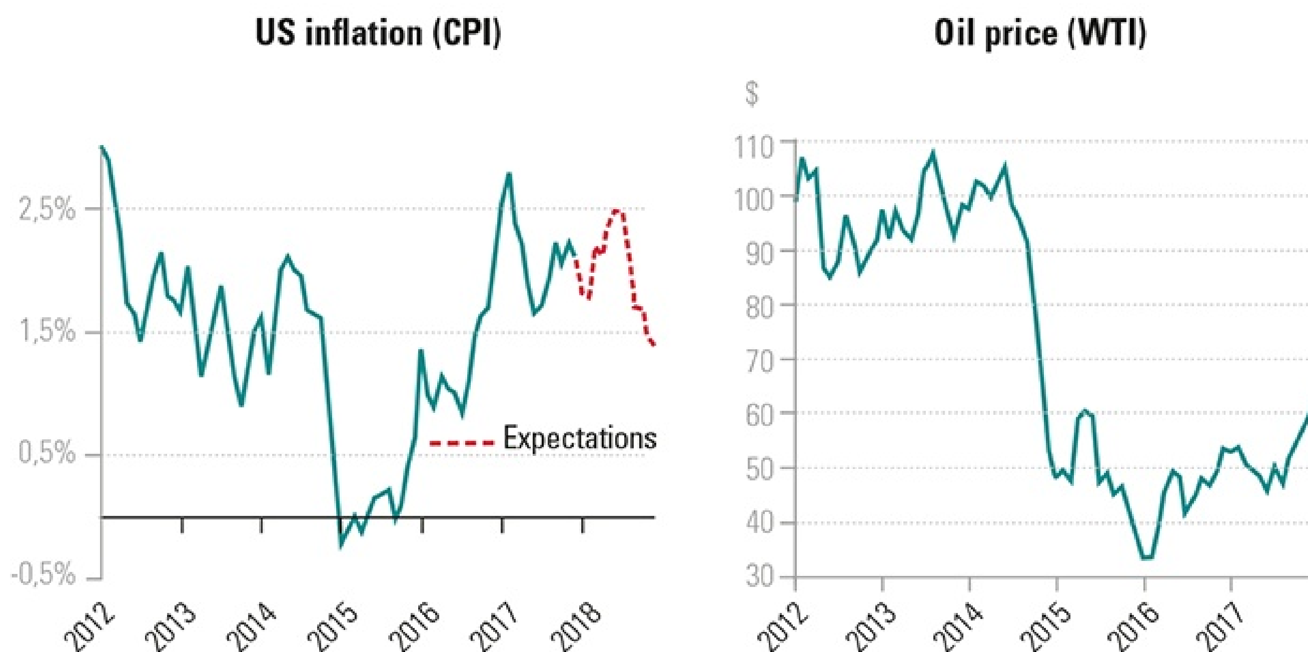
Currencies: Is a new phase of dollar depreciation really in the works?



Source: Bloomberg, 15/01/2018

Global economic growth, now expected to hit 4% in 2018, has continued upwards, while inflation has inched further downwards, vindicating our previous forecasts. With the eurozone economy catching up, emerging markets still going strong, further abundant liquidity in the system and the recently passed US tax reform championed by President Trump, a good many observers now believe that the synchronised global economic boom under way since 2016 can endure without fits and starts, or even gain additional traction. At the same time, economists and traders still forecast an extremely low one-year inflation rate – 1.4% in Europe and 2.1% in the United States. But will the current fairy-tale economy really be a never-ending story?

United States: A disinflation trend doesn't stop fluctuations



Source:
Left: Carmignac, CEIC, December 2017
Right: Bloomberg, 12/01/2018

We feel the expectations just mentioned reflect complacency, particularly regarding inflation. Several perfectly plausible developments could well drive up global inflation. Oil prices are rising, not least because the greenback is falling against most major currencies; wages in countries approaching full employment look set to increase, as widely expected (and feared); and the US economy is in danger of overheating as a result of the recent tax reform, which promises to be so sweeping in scope that its potential impact on GDP growth has yet to be estimated properly.

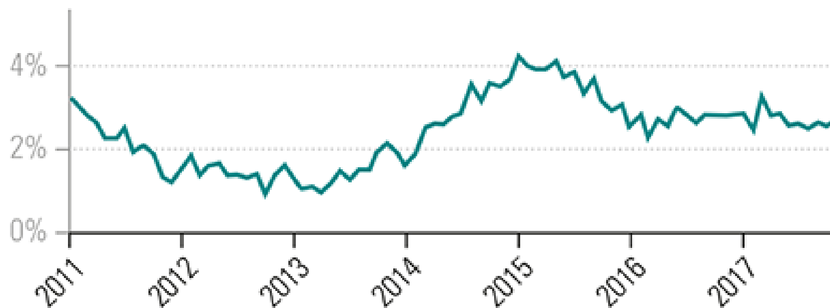
To be sure, that inflationary potential may be offset in large part by such well-identified structural factors as deflationary pressure spawned by the digital economy, the recessionary effect of the necessary global deleveraging under way and the limits created by an ageing population. But any sign of a pickup in inflation at a time of monetary policy normalisation could have a disproportionate impact on financial markets and trigger the wrong responses from central bankers and traders. As regards future global growth, both the normalisation in the works at the world's three leading central banks and our outlook for the US economy leave us slightly less sanguine than the consensus. An about-face in global monetary policy can hardly be entirely innocuous. In the current macroeconomic environment, cyclical trends are once again shaping central bank policy. So what, then, is our baseline scenario? What risks come with it? And what kind of market behaviour are those risks likely to foster?

United States

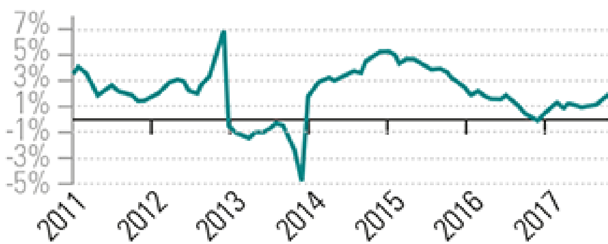
The US economy looks today like it's recovered its lost youth. The new tax reform has boosted GDP growth estimates to the point that the consensus forecast for 2018 now stands at 2.6%. We take a less upbeat view, tax cuts or no tax cuts. For starters, the major catch-up process that has lifted capital spending in the energy and mining sectors won't be providing the same impetus going forward. In addition, we estimate that the new tax system will shave 3% off of corporate tax rates at most – a far cry from the oft-touted 15% reduction. That's too weak an incentive for investing in an economy approaching the peak of its business cycle. We therefore believe that in 2018 the tax reform is more likely to spark a fresh wave of M&A and share buybacks than to stimulate capital spending to any meaningful extent. This is not to say that the new law doesn't matter. It may eventually enhance the US economy's growth potential, above all because it introduces a more favourable tax treatment of capital expenditure and discourages debt financing.

US consumer spending in limbo

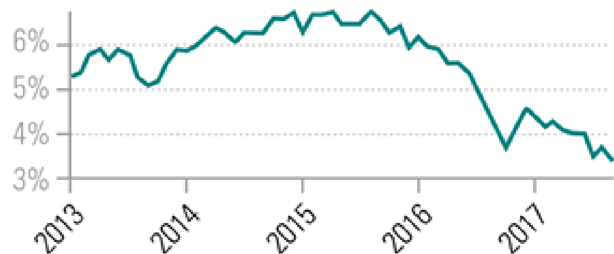
Real consumer spending, y.o.y. change



Disposable income, y.o.y. change



Savings as a % of disposable income



Source: Carmignac, CEIC, November 2017

Moreover, the pay increases granted by a number of large companies in response to the tax reform should in theory give a hike to consumer spending. Unfortunately, in light of the country's low savings rate – around 3% – and the recent record of what happens when US disposable income goes up, consumers are more likely to squirrel away a large share of their extra money. US exports could certainly be buoyed by a weaker dollar and therefore contribute to GDP growth, but it would be a mistake to place too much hope in that

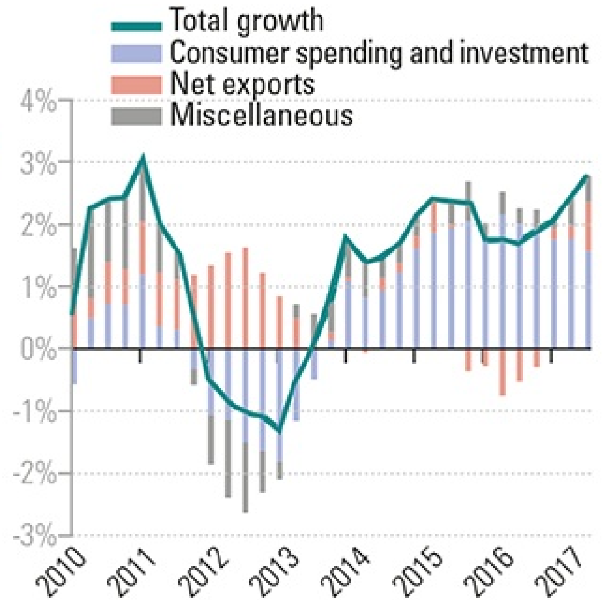
prospect now that imports by other world trade heavyweights appear to be winding down: China, South Korea and Germany have all recently published lacklustre import numbers.

Another factor with the potential to unsettle the US economy is inflation. Between March and July, the low comparison basis for energy prices should push the CPI up by anywhere from 1.7% to 2.5% – even if energy prices stop rising. Furthermore, as the US jobless rate sinks towards the 4% mark, inflation fears are likely to intensify. The combination of those fears with possible disappointment on economic growth will put the country on shaky ground at a time of ongoing monetary policy normalisation. Even if any economic reversal is limited in scope and any increase in inflation short-lived, they can be expected to occur concurrently in the next quarter – and therefore generate volatility, while offering the US economy a welcome breather. Admittedly, the trend reversal we expect could be pushed back again if the persuasive Donald Trump manages to talk Congress into endorsing his infrastructure plan. But if he does, we will be confronted with an overheating economy, along with all the pain that that implies.

Europe

Europe, meanwhile, has delivered pleasant surprise after pleasant surprise. France's economic output and business and consumer sentiment show marked improvement. Germany has proved resilient enough to take the lengthy process of forming a coalition government in its stride. And finally, Italy has begun – somewhat like France but with fewer reforms – to make up for years of lost growth during the eurozone crisis. Political developments in Spain and Italy's March elections are likely to slow the currency bloc's momentum, which is getting a boost from a highly favourable monetary policy. With normalisation yet to come, German sovereign yields continue to hover in the vicinity 0.5%, despite the eurozone's 1.7% inflation rate and 2.7% annualised growth rate in the third quarter of 2017.

Eurozone: An upswing highly dependent on global economic growth



Source: Carmignac, CEIC, December 2017

The euro's strength since early 2017 may ultimately hobble the region's economic expansion by making it harder to export outside the currency bloc. Not only do the eurozone's net exports account for nearly a third of GDP growth; they have also been its biggest driver over the past several quarters. Perhaps more than ever before, the current upswing in Europe should be viewed as the result of growth elsewhere in the world economy. On the other hand, the region has considerable potential for catching up after years of underperformance, and its abnormally low interest rates still offer major opportunities to spur growth before the normalisation process kicks in.

Emerging markets and Japan

Loose monetary policies in advanced countries and a weaker greenback continue to provide most emerging markets with powerful tailwinds. Both factors enable them to pursue accommodative monetary policies wherever price trends make that possible – thereby letting them enjoy ample liquidity.

Judging by more reliable metrics such as rail freight volume and electric power consumption, China appears to be undergoing a mild slowdown. The Li Keqiang Index, which tracks those indicators of real industrial activity, has been trending downwards for the past year. Much the same can be said of credit growth, which

has fallen below the 15% threshold in recent months. The government is quietly doing what it takes to avoid losing control of a slowdown that it views as positive. Elsewhere in Asia, although the Chinese slowdown has put a minor crimp in exports, the various currencies have still appreciated, thanks to ongoing improvement in current account balances. In the rest of the world, commodity-exporting countries are reaping the benefits of the rebound in commodity prices. Russia and Brazil are prime examples, but their healthy economies offer no leading indicators of relevance to the emerging world as a whole. As both of them operate at the end of the production chain, they usually lag behind the regional and global business cycle.

Slowly but steadily, the Japanese economy is recovering. The Bank of Japan can now provide less support than promised, given that there is less of a need for it today. The country has begun gingerly to normalise monetary policy, moving in the same direction as the US and soon Europe. The challenge for us is to determine whether the pace of such concerted normalisation is in keeping with global economic growth.

Investment strategy

As the economy gradually returns to normal, cyclical considerations will recover their former influence on monetary policy – which is great news for active managers. An increasingly synchronised, relatively robust cyclical upswing substantiates current moves to normalise monetary policy and paves the way for higher interest rates further down the road. We are less sanguine than the consensus about the global growth outlook. Not only do we not believe the US economy will expand by 2.6% as forecast, but we also think that the reversal we see coming, combined with a controlled slowdown in China, will lead to lower-than-expected-global growth accompanied by a mild uptick in inflation. Our assessment has implications for all three primary asset classes.

In currencies, we see further appreciation of the euro and, in broader terms, a weaker greenback. The spillover of US economic growth to the rest of the world will contribute to that weakening, particularly if the trend reversal in the United States unfolds at a moderate pace, as we expect. The recently passed tax cuts should offset in part the petering-out of the US boom, a factor that would otherwise limit the potential for consumer and capital spending. That outlook has prompted us to hedge our entire US dollar exposure as we enter the new year.

In bonds, the gradual convergence in sovereign yields between the United States and Europe that got started in the fourth quarter is likely to continue. With the US expansionary cycle drawing to a close, we expect the Fed to carry out fewer rate hikes than scheduled, thereby pushing down the long end of the yield curve. But as fears about inflation are bound to resurface from time to time, we don't see Treasury yields falling too sharply. In Europe, an increasingly broad-based upswing, combined with the imminent announcement by the ECB of monetary policy normalisation, should strengthen the rise in eurozone sovereign yields and therefore narrow the gap with US Treasury yields. Our investment approach will involve taking advantage of any drop in German bond yields to position our Funds for a subsequent turnaround. As the ECB moves to normalise its policy stance, just how anomalous Germany's low bond yields have been will at long last hit home. And all the while, local-currency debt from a select group of emerging markets will continue to offer plenty of opportunity.

In equities, stock markets have already priced in the favourable macroeconomic climate, along with the near-term effects of US tax reform. The trend reversal we expect to see in the United States may initially hurt cyclical businesses, whereas companies with no major debt, decent returns on capital and operating in high-growth sectors like IT should come out ahead. At the other end of the spectrum, we believe the energy industry will continue to reap the benefits of drawdowns in global oil inventories, particularly because the further depreciation of the US dollar we anticipate should enhance the sector's appeal to investors. We will also maintain our preference for emerging-market stocks. That part of the world stands to benefit from a weaker greenback and more moderate upward pressure on US interest rates. A stronger euro, meanwhile, is likely to continue to put European equities at a relative disadvantage, suggesting the need to favour domestically-oriented firms. In summary, we feel that the economic trend reversal we see coming holds out a good many attractive investment opportunities.

Source of data: Carmignac, CEIC, 29/12/2017

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