

MANAGEMENT REPORT – SECOND QUARTER OF 2018

Q2 2018

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12.07.2018**Economic analysis**

“America First” turns out to be more than just a slogan. It’s actually the name of an unabashed policy that is having a positive influence on US economic sentiment. By shifting gears and powering ahead – while the European Union is marking time – the US is dragging the world economy into a state of antagonism that the country’s monetary policy normalisation can only heighten. Tightening by the Federal Reserve has already begun to create a global liquidity drain, and exacerbated by the ongoing rise in oil prices. Add Donald Trump’s trade war threats to the mix and the dramatic regime change under way becomes bitterly clear. Because those shifts are occurring simultaneously, we argue that they should be viewed as indicators to an increasingly fragile, largely played-out system, rather than as one-off factors with unrelated causes.

The global outlook

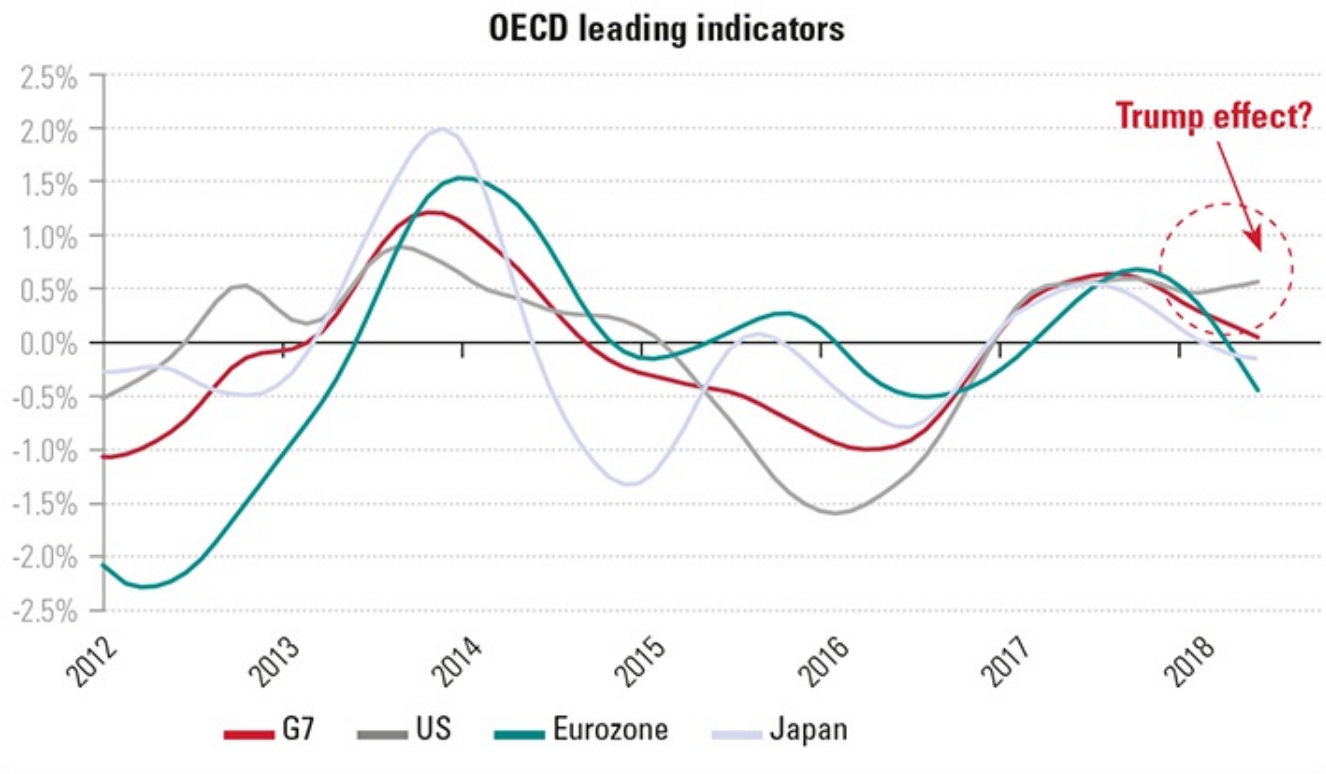
In our previous report, we wrote: *“The moderate economic slowdown we anticipated seems to be taking shape, but slightly later than expected due to the initial impact of US tax reform. The geographic areas most exposed to cyclical trends are in fact the ones currently showing the greatest weakness, thus supporting the argument that lower US taxes have delayed the deceleration in output”*. Whereas the slowdown in such cyclically vulnerable regions as Japan, Europe and a number of emerging markets is already palpable, it has yet to materialise in the United States.

As the no-holds-barred application of the “Make America Great Again” catchphrase that worked so well during the presidential election campaign, “America First” turns out to be more than just a slogan. It’s actually the name of an unabashed, unconstrained and virtually unrestricted policy that is having a positive influence on US economic sentiment.

A tax reform designed to boost business investment and consumer spending, pressure exerted by Washington to shift world trade to the USA’s advantage and a stepped-up crackdown on illegal immigration are the most visible features today of an America-centric approach. They also explain to a large extent why the US economy is currently doing so well – at the expense of the rest of the world.

The slowdown is clearly under way in Europe and Japan

But the US economy's resilience is evident



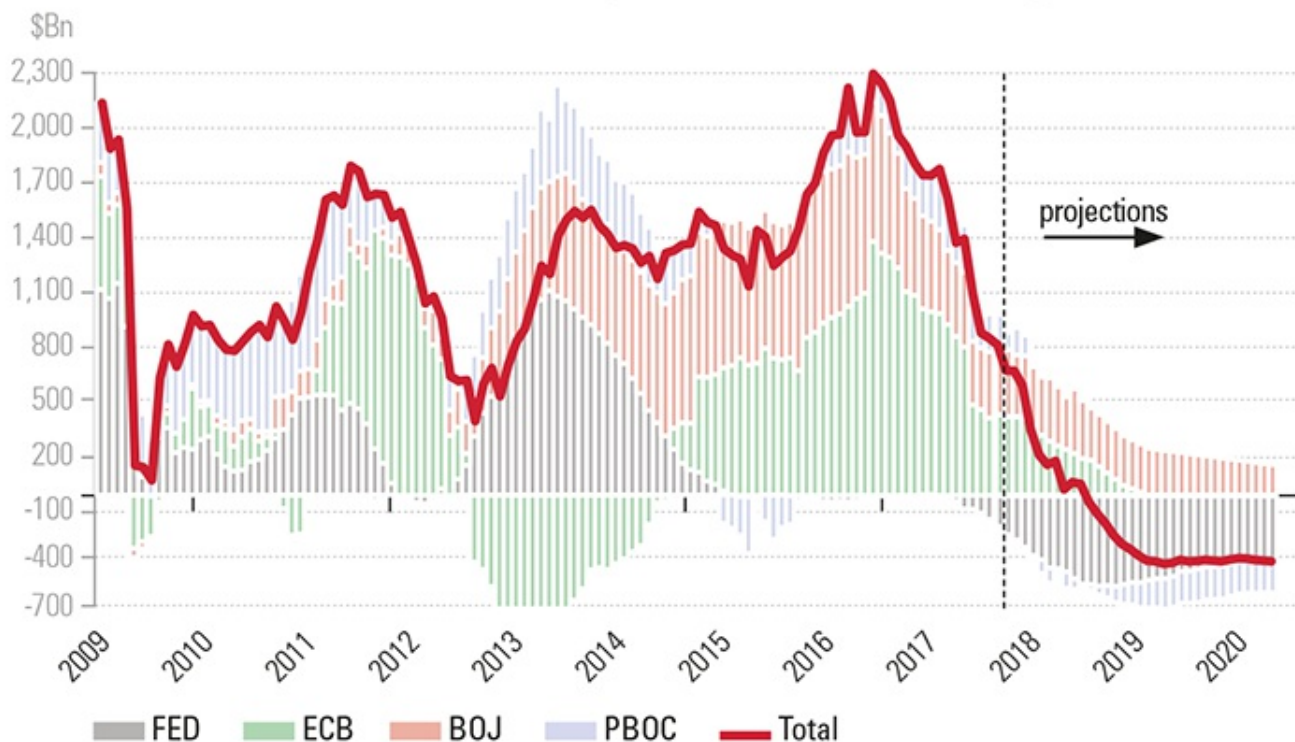
Source: OECD, Carmignac, May 2018

We can now see with hindsight how and why those aggressive policies, whose economic fallout we previously underestimated, together with the most recent demonstration of how little unity the European Union can muster, has radically shifted the euro-dollar exchange rate, contrary to what we expected. That rate has proved largely immune to the anticipated surge in the Federal budget deficit, given the widening growth-rate differential between the US and the eurozone. As a result, emerging-market assets were likewise hurt which weakened the performance of our global and emerging market funds during the second quarter.

By shifting gears and powering ahead – while the European Union is marking time – the US is dragging the world economy into a disturbing state of antagonism that the country's monetary policy normalisation can only heighten. Tightening by the Federal Reserve has already begun to create a global liquidity drain, exacerbated by the ongoing rise in oil prices. Whereas the world's leading central banks previously pumped over \$200 billion per month into the system, the global economy and financial markets will now have to adjust to a monthly cash injection rate of just \$50 billion – which from October on, will fall to less than \$23 billion and ultimately to net monthly liquidity withdrawals of \$5 billion starting in January 2019 if those banks stick to their declared plans.

Liquidity: a major regime change for markets, with the Fed leading the way

Balance sheets of the leading central banks, annual change (\$bn)

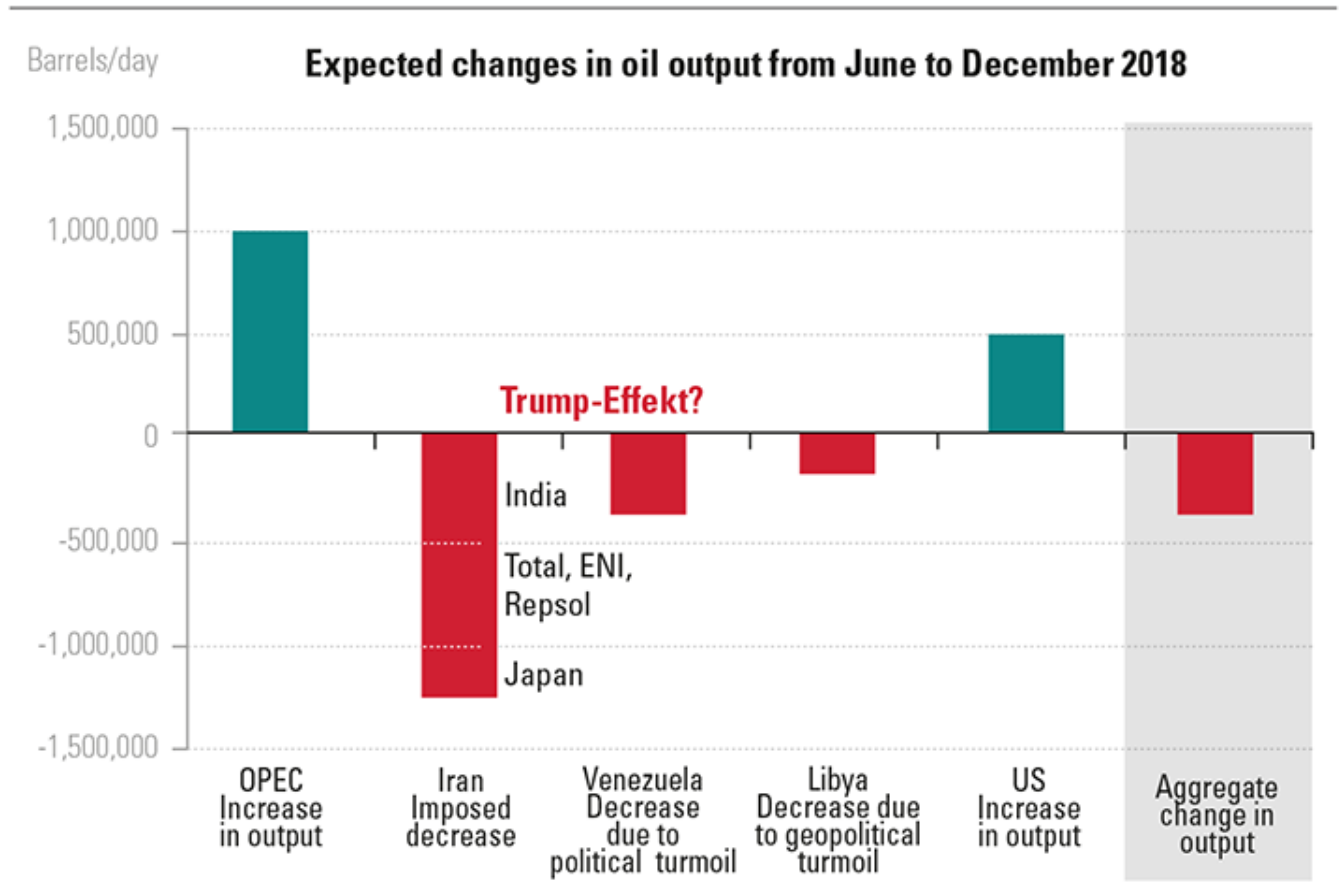


Sources: Bloomberg, Carmignac, July 2018

Meanwhile, the \$10 increase in oil prices over a six-month period has already reduced the discretionary spending capacity of businesses and households by \$100 billion. Moreover, there is little indication that the price rise will stop there. Add Donald Trump's trade war threats to the mix and the dramatic regime change under way becomes bitterly clear, particularly as a contraction in trade will further curtail global liquidity. A surging dollar is both cause and effect in this case. Among the stronger dollar's first casualties are upward pressure on bond yields in the countries most dependent on external financing (e.g., Italy and Turkey) and both currency depreciation and falling stock prices in emerging markets – not to mention widening credit spreads on high-yield corporate bonds and the decreasing market value of European banks. Because those momentous shifts and local tensions are occurring simultaneously, we argue that they should be viewed as indicators to an increasingly fragile, largely played-out system, rather than as one-off factors with unrelated causes.

Each of the three forces driving the liquidity crunch are shaped to a considerable degree by politics, and not just by economics. After all, if the Fed presses ahead with monetary policy normalisation, it would be because Trump's policies make such a move possible, or even advisable. Likewise, if oil prices continue upward despite the steps taken by OPEC and Russia to ramp up output, it would be at least in part because Trump aims to ban oil exports from Iran.

Trump's unyielding attitude is driving up oil prices



Source: Carmignac, 29/6/2018

Lastly, if world trade sags further, it would also be to some extent due to Trump going through with his threat to impose high tariffs. The major regime change under way could have a major impact on the global economy and financial markets – but it isn't set in stone, either. Due to the US President's inherently mercurial character, his style of politics may well engender significant reversals, which need to be anticipated. These are likely to occur when the pendulum swings too far, when the political agenda allows the White House to take a less black-and-white approach to today's contentious issues, or – and most importantly – if and when investors clearly show their disapproval of a Trump method they have come to consider economically counterproductive. The "Goldilocks" economy – in which mediocre GDP growth, low inflation and overabundant liquidity created an environment supportive of financial markets across the board – has come to a halt around the world, but without seriously affecting the United States. The relevant question is how long that country will sustain its boom, considering it's the only one left with a vibrantly expanding economy.

United States

For the time being, the Federal Reserve and the White House are putting their money where their mouths are. Under the leadership of its new Chairman, Jerome Powell, the Fed is selling \$20 billion worth of bonds bought between 2008 and 2014 per month and is steadily raising its benchmark rate, which now stands at

2.0%. Apparently getting a second wind from Trump's first initiatives, the vigorous US economic boom is allowing the Fed to go on normalising monetary policy, unlike central banks in the other major economic regions, whose strong performance in 2017 doesn't seem to have carried over into 2018.

At the same time, Trump is determined to implement the campaign promises that got him elected. His policies are directed at Middle America, where unconventional monetary policy has brought declining social and economic status more often than financial windfalls. These policies include tax cuts for households and businesses, tax incentives for big US companies to repatriate hundreds of billions of dollars in profits they have earned abroad and hitherto stashed in overseas bank accounts, a sharper crackdown on illegal immigration and demands for "fairer" trade as defined by Donald Trump (meaning more advantageous to the United States). Further down the line, we can presumably expect an infrastructure spending plan and an overhaul of the US healthcare system. But these last two points in the programme can't be carried out unless the Republicans win majorities in the November midterm elections that exceed the ones they have today in both houses. With this important electoral contest fast approaching, President Trump has taken a harder line than expected, both on immigration and on defending American companies against their global competitors.

Given the current state of the US economy, however, such a belligerent approach to the country's trading partners will probably be difficult to sustain for much longer. The same goes for the current pace of monetary policy normalisation. Though still quite strong, several of the country's main leading economic indicators already show signs of weakness. For example, while the growth in capital expenditure has continued at a high, 9.2% pace, it shows no acceleration despite the tax incentives meant to promote just that. Similarly, though consumer spending is still advancing at a 2.3% clip year-on-year, the annualised rate over the past six months has fallen to just 1.5% – a five-year low. Moreover, that slide has occurred even with lower taxes and, in some cases, pay increases and one-off bonuses granted by companies that have themselves benefitted from tax cuts or generous incentives to repatriate profits earned abroad. The household savings rate has remained low at 3.2% thanks to sanguine consumer confidence, but we see a good chance that it will gradually pick up.

Likewise, if the rise in oil prices continues, it may well portend an end to the exceptional GDP growth enjoyed by the US, as it would put a dent in household disposable income. "Trumpian" geopolitics, with its urge to eliminate Iran as an oil supplier, suggests to us that expensive oil won't go away any time soon and will likely lead to a conventional late-stage business cycle combining weaker consumer and capital spending – due in part to higher oil prices – with interest-rate hikes justified by inflation, one of whose key drivers is oil.

As we anticipated, US inflation has gained further traction since it began rising in mid-2015. It reached 2.8% in May (a six-year high), or 2.2% excluding volatile food and energy prices. We believe inflation will continue to inch up until July, before easing once again. On the other hand, we can't entirely rule out the prospect that it will continue rising beyond then, or remain at a high level. Expensive oil and full employment (a 4% jobless rate at present) could set the stage for a spiral in which wage inflation and rising prices for goods and services fuel each other, and thus eventually start to eat away at corporate profit margins. But whether US output falls for cyclical reasons or is pushed down by the Fed, financial markets will have to adjust in a big way to a GDP growth rate far different from the one they are currently pricing in before they can hope to see the Fed go dovish once again.

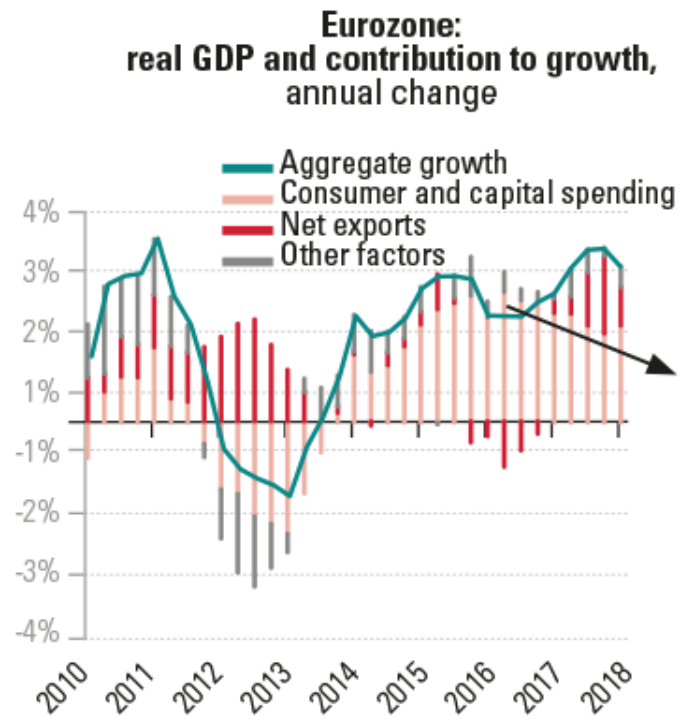
Europe

Europe's economy, meanwhile, is decoupled from the US. Since the first quarter of 2018, eurozone growth has been disappointing, in part a consequence of more sluggish world trade.

Eurozone: slowing domestic growth coupled with less support from exports



Sources: Carmignac, CEIC, May 2018.



Sources: Carmignac, CEIC, March 2018.

Sources:
Left: Carmignac, CEIC, May 2018
Right: Carmignac, CEIC, March 2018

For the full year, the eurozone's output is expected to reach 2.2%, down from 2.4% in 2017 and in contrast to the 2.9% forecast for the United States, up from 2.3% last year. That change is in part attributable to political factors. Agitation by Catalan separatists, a governing coalition of far-right and far-left in Italy, mounting discontent reflected in the election of extremist parties in Central Europe and, lastly, a weaker Angela Merkel have undermined the European construction process, and with it economic sentiment. At close to 2%, the growth rate of industrial production in the eurozone is lower than at any time in the past year, as is retail sales growth at 1.5%. In Germany, the falloff in world trade has already had a noticeable impact, with orders for durable goods from outside the eurozone down 3%.

Strikingly enough, the slowdown in both Europe and Japan is occurring before the US economy shows any sign of faltering, although both of the former still enjoy highly accommodative monetary policies. Weaker growth is the driving force behind much of the popular discontent with the EU framework, causing endless headaches for European politicians. Under those conditions, the hope – dashed over and over in recent years

– that Germany will loosen the fiscal purse-strings to reboot growth on the continent may not be all that far-fetched, particularly as it could help offset the monetary policy normalisation process the European Central Bank is expected to initiate. The ECB plans to halve its asset purchases to €20 billion a month starting in October and then end them entirely as of January 2019.

Emerging markets and Japan

In the emerging world, the threat of a trade war has aggravated the impact of dwindling liquidity and a stronger US dollar. Aside from a few exceptions (as in India), emerging market currencies and stock markets are experiencing a substantial decline that stems from the unfolding global liquidity crunch, a stronger dollar and the growing challenge to free trade. Argentina and Turkey, both of which have significant dollar-denominated debt, are the most visible casualties, but their fate gives a good indication of what the about-face in monetary policy could mean for markets around the world unless that policy shift is implemented with restraint and with adequate equilibrating measures.

As the November midterm elections loom up, the trade standoff pitting the United States against China is likely to grab headlines to such an extent that market participants may not lessen their perception of emerging-market risk, above all if the dollar climbs further. In China, domestic growth is on the wane. The increase in retail sales has slid further to just 6.7% from 9.5% a year earlier. Meanwhile, credit growth has fallen to 12.5%, a low since 2015. The threat of punitive tariffs can hardly be taken lightly by a country whose sales to the United States are nearly four times as high as its purchases from the US.

Even so, we don't believe we are heading for an out-and-out trade war and a major decline in world trade. We expect on the contrary that better, fairer practices will eventually be introduced, particularly regarding intellectual property. And in that area, the United States has a good case.

Investment strategy

Monetary tightening – a shift well under way in the US and forthcoming in Europe – combined with higher oil prices, threatening discourse on world trade and a stronger US dollar will crimp market liquidity. Some of the weaker links in the chain, such as Argentina and Italy, have already taken a serious hit.

The mild economic slowdown we still anticipate in the United States should heighten investor skittishness towards risk assets, an attitude we have factored into our global strategy by reducing our equity exposure to 86% in the case of Carmignac Investissement and to 26% in the case of Carmignac Patrimoine. However, we don't subscribe to a doomsday scenario that would warrant immediate, drastic risk reduction. In our view, the threat to world trade has been grossly exaggerated by pundits and even market participants, and is likely to fade before the summer is out. We also believe that the evidence for rising inflation in the United States is still thin and that the US economic slowdown may not become apparent until some time in autumn. That means that current conditions in the financial markets are optimal for us to drastically derisk our portfolios.

In the equity market, we have maintained our exposure to US oil companies, because Trump's unyielding attitude towards Iran in particular suggests that crude oil prices will stay high. We remain overweight tech stocks, which we view as both less vulnerable to the business cycle and likely to gain ground at a time when

interest rates are being pushed up by monetary policy normalisation. We also continue to favour relatively non-cyclical US companies, especially as the new tax law provides strong incentives for them to buy back shares. After the severe correction they have suffered, equities in the emerging world – China in particular – could well stage a major rally once the current trade tensions have subsided. It is worth mentioning that they are less vulnerable to a global liquidity crunch.

The various sovereign bond markets show a fair amount of divergence. The only way to explain why German 10-year yields are as low as 0.3% is that ultra-loose monetary policy has continued a bit longer than anticipated. But in light of the side-effects that is producing and the mounting criticism regarding those side-effects, that policy may well be on its way out. Though US 10-year yields could certainly hold steady at below 3% due to the expected economic slowdown, the monetary policy normalisation under way and the resilience of the US economy make it unlikely that they will drop sharply. Corporate credit calls for considerable caution at a time of dwindling liquidity, whose negative impact – already observable – could be greatly amplified if the US economy were to slow substantially. In the forex market, it is unclear how the euro-dollar exchange rate will play out. In the medium term, deepening fiscal and trade deficits in the United States point inevitably to a weaker dollar. But in the short term, the country's brazenly healthy economy, its beggar-thy-neighbour treatment of its trading partners and monetary normalisation by the Fed should translate into further appreciation of the dollar. The currency exposures of our portfolios are therefore roughly in line with those of their reference indicators. However, we have also moved to short the yuan against the dollar in order to hedge against the possible risk of an escalating trade "war".

Source: Bloomberg, 29/6/2018.

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