

ECONOMICS AND POLITICS WENT DOWN TO THE RIVER TO BATHE

March 2017

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01.03.2017



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After observing that every new political twist and turn in 2016 fed into a gradual drift towards fiscal interventionism and prompted central banks to reaffirm their accommodative monetary policies, the financial markets have since been having a field day with what is clearly the strongest cyclical recovery since the end of the Great Recession. Not only is the US upswing already well under way, but “Trumponomics” makes it reasonable to expect that it might continue.

At the same time, Europe’s cyclical lag in relation to the United States leaves the region plenty of room for catching up. The same holds true for Japan. Investors in the English-speaking world are of course maintaining a safe distance from Europe “just in case”. Oddly enough, they actually appear to be much more concerned over

political risk in France today than in early 1981, prior to François Mitterrand's surprise victory in the country's presidential election. Today the effect of those concerns has been to prolong the nagging underperformance of European equity markets and more recently to nudge up the risk premium on French government bonds. Furthermore, the technical indicators tracked by active investors are beginning to show some battle fatigue.

But with the wind of economic recovery in their sails, stock markets have been gradually putting investor misgivings to rest (although the process is taking longer in Europe). Perhaps because they are comforted by underlying trends – or because they can't take their eyes off the political agenda – market participants still seem blithely unaware of one of the more tangible risks in 2017: mounting inflationary pressure (see our paper, [“2017: Be careful what you wish for”, January 2017](#)).

What's good for the economy ...



Trump has opened rifts in American society, but his economic policy agenda has also sparked excitement.

Though the Trump persona has repeatedly baffled observers, the “unpredictability” he has introduced into the equation should not be overstated. To start with, the new President's trademark communication style is much less bungling than is commonly assumed. Precisely because an unremitting barrage of sketchy tweets offers endless flexibility, they are being increasingly taken with a large grain of salt. In addition, Donald Trump's inexperience in essential areas has compelled him to assemble a team of seasoned professionals, as Ronald Reagan did before him.

Lastly, there is nothing unpredictable about his economics. Trump subscribes to a rather primitive but consistent form of mercantilism that gives the Federal Government a determining role in defending the economic interests of the United States and shrinking its trade imbalance.

That makes the general thrust of his economic agenda tolerably clear, both for the US and for its trading partners. And in any event, a Congress marked by a very conservative stance on key fiscal and tax issues is counted on to keep that agenda within reasonable bounds. So while Trump's arrival at the White House has certainly opened deep rifts in American society, it has also sparked virtually unanimous excitement with regard to economic policy. The consumer confidence index has surged impressively since 9 November. More crucially from an investment standpoint, the NFIB small business optimism index has shot up since the election to its highest level since 2004.

Further confirmation of the reawakening of "animal spirits" suggested by those surveys was provided by a 5% increase in US corporate profits during the fourth quarter of 2016 – a rebound that beat analysts' forecasts two thirds of the time.

In Europe, it is no less striking that the upcoming high-stakes elections in 2017 have had little impact on the economic upturn under way. The manufacturing Purchasing Managers' Index for the eurozone has likewise confounded overwhelmingly downbeat expectations, rising 1.6 points in February to 56, a high not equalled on the continent since April 2011. These readings have led more and more financial analysts to upgrade their forecasts for corporate profits in 2017, which they now predict will add an average of 15%.

EUROZONE: EVOLUTION OF THE PMI INDEX



Bloomberg, 01/03/2017

The electoral timetable in Europe has so far prevented investors from fully responding to such a promising economic outlook. But if the various elections turn out reasonably well, they could clear the decks for a vigorous rebound in both stock prices and the euro – particularly if the winners are voted in on sensible economic platforms.

The Phantom Menace

Election risk in Europe cannot be dismissed lightly, however. After all, it's hard to see why the populist tide that has been sweeping the global political scene for over a year would magically halt at the eurozone's borders. The benefits of globalisation have been unevenly distributed in developed countries, and proponents of greater national sovereignty have gained a hearing that large-scale immigration has clearly boosted. If political debate in the run-up to Europe's various elections were to revolve solely around issues of national identity – which almost unfailingly go hand in hand with calls for protectionism – the economic consequences of the various

campaign platforms would receive very little attention, leaving the field wide open for demagogues whose programmes, if implemented, would destroy wealth virtually across the board.



The Trump phenomenon can't be replicated in Europe.

Donald Trump's victory at the polls expressed a form of insurgency that has worked to the advantage of the US economy (for the time being at any rate). But the Trump phenomenon can't be replicated in Europe. The world's number-one power is in a position to force a nationalistic economic agenda on its trading partners, even if such a policy may eventually generate serious problems. In contrast, no economy in Europe – not even Germany's – can afford to go it alone within a disunited European Union. It is not unreasonable to expect that the idea of committing economic suicide for the sake of ersatz sovereignty won't appeal to a majority of voters in France or elsewhere in Europe. Even so, it will be important to maintain a prudent stance as the various election dates approach. Although a major shock looks unlikely at the present time, if it does come about, the economic fallout will be extensive.

The risk of inflation still underestimated



The signs of rising inflation continue by and large to be disregarded.

Mindsets often take time to adjust to a changing reality. Today for example, central banks and fixed income markets continue by and large to disregard the increasingly unmistakable signs of rising inflation (see our [January Note](#)). And yet the year-on-

year rate of change in US consumer prices accelerated again in January from 2.07% to 2.5%, chiefly due to higher transportation costs. In the euro area, the rate of inflation rose from 1.1% to 1.8% over the same period.

The claim that the recent uptick in inflation is entirely attributable to a base effect – by definition a short-lived factor that will soon disappear – leaves us unconvinced. Energy and food price increases tend to spread to the rest of the consumer price index with a lag. US inflation excluding food and energy prices already climbed to 2.27% in January, and that is even before the upward drift in wages has had time to kick in. We would therefore argue that if it weren't for concerns about political risk in Europe, which are driving down yields on safe-haven government bonds and keeping central bankers on their toes, yields on ten-year US and German government paper (currently 2.46% and 0.30% respectively) would be substantially higher. As soon as they look beyond the short-term political risk in Europe, investors should be very careful about their portfolios' sensitivity to interest rates in the primary developed countries. That is the approach that we have already adopted.

To summarise, a cyclical recovery is unquestionably under way in the United States and political risk in Europe is no paranoid phantasy. But pervasive doubts about the health of the economy, compounded by fears of a populist victory in France and the Netherlands, have led many investors to shy away from equities since the start of the year, above all in Europe. Their apprehensive attitude towards that particular asset class is reassuring from a technical standpoint, as it means they apparently haven't priced in the likelihood that Europe's frail economic recovery until now may soon get going in earnest once the political fog has lifted. On the other hand, such investors underestimate the risk to fixed income markets of inflationary pressure, which we believe will grow.

Investment strategy

Equities

Equity markets started the year on a decidedly positive note. Even though political uncertainty has constrained performance in Europe, despite the strong macro- and micro-economic data in the region, gains were recorded across all geographies. We have accordingly maintained our equity exposure at close to the maximum allowed level, while sticking to our selective, balanced approach to portfolio construction.

We call it selective because we buy the stocks of companies that are well-positioned to benefit from the unfolding economic upturn but that also show sound fundamentals. A prime example is ASML, a manufacturer of chip-making equipment in which we recently invested. The company combines business cycle sensitivity with market leadership and a solid balance sheet, thus offering good earnings visibility.

We call our approach balanced because we also hold positions that are unrelated to our reflation theme. This approach is epitomised by two stocks we recently added to our global equity strategy. One is Activision Blizzard, a US video game developer whose shift to a business model based on more regular revenue streams – i.e., less dependent on coming out with new blockbusters – is still underappreciated by investors.

Risk management remains a key component of our global equity strategy, alongside our constructive positioning in markets. The gold stocks we hold have posted handsome gains since the beginning of the year. As previously, they are helping to keep overall portfolio risk down.

Fixed income

Though inflation has continued to accelerate across the developed world, nominal long-term yields have held fairly steady. We maintain that investors' inflation expectations are too conservative. In our view, the general uptick in prices can't be dismissed as a short-term byproduct of the rebound in oil prices; it reflects a broader, more sustained trend. We have therefore invested in US Treasury Inflation-Protected Securities in order to limit the risk in our fixed income portfolio while shielding us against a surge in inflation.

Finally, we made some changes to our emerging market debt holdings, exiting our position in Polish debt and shorting Hungarian debt. We see a clear-cut divide developing in the emerging market debt space. On the one hand, you have commodity-importing countries like Hungary, where inflation is gathering real momentum and bond yields are still quite low. On the other hand, you have commodity-exporting countries that combine high bond yields with a significant easing of inflationary pressure. Brazil, representing our largest emerging market debt position, is a case in point. Inflation has just fallen to below 5.5% and the central bank has apparently kicked off an aggressive rate-reduction cycle with two 75 bps cuts to its key Selic rate since the start of the year.

Currencies

The US dollar has seesawed since the beginning of 2017, with no clear trend emerging. Those ups and downs validate our view that the highly positive consensus on the greenback sets a limit on any further appreciation of the US currency. We have therefore increased our exposure to the euro and lowered our exposure to the dollar.

With major elections coming up in Europe, we have opted for a mix of positions in haven currencies like the Swiss franc and the yen to keep our overall portfolio risk under control. A final trend worth noting is the ongoing appreciation of emerging market currencies. We are taking advantage of this trend through our local currency positions, as in Brazil, that are not hedged against currency risk.

Source: Bloomberg, 01/03/2017

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