



False starts, but no change in finish line

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Capital flows back into the eurozone should partially protect European equity markets against bond risk and strengthen the single currency

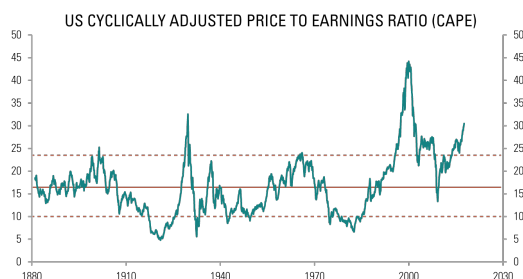
As the last quarter of 2017 gets under way, a rather puzzling fact is that neither the European Central Bank nor the US Federal Reserve has actually initiated the next stage of the monetary policy “normalisation” announced by both, whereas the macro backdrop unequivocally says they should. The Fed has made modest headway, but remains extremely dovish. The ECB, however, hasn’t budged, although eurozone economic growth amply exceeds its long-term potential and inflation expectations have steadied, or even picked up. US GDP growth is holding up well and the labour market is getting tighter by the day.

The central bankers in both regions also need to deal responsibly with asset price inflation – instead of pouring more fuel on the fire. Perhaps they’re worried that the string of political risks we’ve seen since the summer of 2016 will go on. Or frustrated at failing to hit their official inflation targets. Or just plain scared of the financial markets. Whatever the reason, central bank policies are still vindicating those investors who believe the day of reckoning can be endlessly postponed. The recent series of false starts has prolonged the positive correlation between stocks and bonds – a seemingly miraculous, but wholly artificial situation. As a result, the combination of a cyclical recovery and monetary policy support is still offering investors a cocktail heady enough to keep driving the prices of all asset classes relentlessly upwards. With easy money apparently so ready for the taking, risk management seems to have gone out of style.

The trouble, however, is that the finish line on the monetary policy obstacle course is still out there. In fact, central bankers now admit that it’s looming up fast. Fixed income investors are unprepared for the upcoming inflection point, while equity investors are praying that bond conditions will endure so that they can escape the gravitational pull that bond prices will inevitably exert.

The line in the sand

Federal Reserve Chair Janet Yellen has explicitly stated that the US central bank will start unwinding its balance sheet this autumn, bringing eight years of unprecedented expansion to a halt. The easy financing conditions created by a weak dollar, together with the tax reforms recently proposed by the Trump administration, make such a shift that much more likely. Moreover, Mario Draghi is heading down the same path. In October, he will set forth the specifics of how the European Central Bank will gradually taper the expansion of its balance sheet. For the first time since 2008, the combined balance sheets of the world’s four largest central banks will begin to shrink next year. But the financial markets apparently haven’t registered that yet – behaving as if “infinite quantitative easing” were still a plausible scenario.



Source: Bloomberg, 29/9/2017



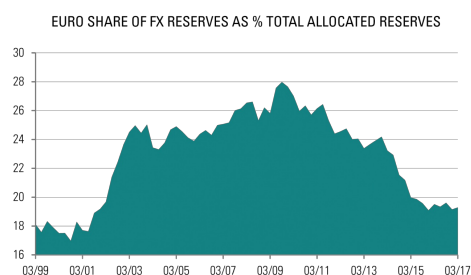
In the United States, such complacency is somewhat understandable. We, too, believe that the current cyclical expansion has only a few quarters left. Manufacturing already shows signs of running out of steam (see our September Note, "[The lightning-rod strategy](#)"). Household spending is being propped up by an unprecedented increase in consumer credit and a substantial drop in the savings rate – yet both of those factors have very little scope to progress further, particularly once interest rates begin to rise. It therefore seems sensible to expect that higher interest rates in the United States won't last long.

As soon as the economy shifts into reverse, the Fed will not be able to ignore that further policy tightening would only make that shift worse. In fact, that prospect is already reflected in the stubbornly flat US yield curve. It is also what explains why growth stocks are once again outperforming cyclical stocks in the United States this year, and why the dollar failed this past summer to regain more ground following an eight-month losing streak. Even assuming that the Trump administration's long-overdue tax cut proposals make it through what promises to be a complicated budget process, they still won't pack enough of a punch to forestall the trend under way.

"Europe, Europe, Europe"

Europe's bond markets won't be able to escape the liquidity crunch the ECB is poised to inflict on them

As Charles de Gaulle put it over fifty years ago, it is pointless to repeat the word Europe as an article of faith: "We have to take things the way they are." The 2008 financial meltdown dealt a heavy blow to the dream of convergence across the eurozone. Economic performance has diverged widely between Germany and the other members, leading to extremely polarised public opinion. In a telling sign of the resulting European identity crisis, businesses, investors and global asset managers have been turning away in droves from the single currency for almost a decade (see chart).



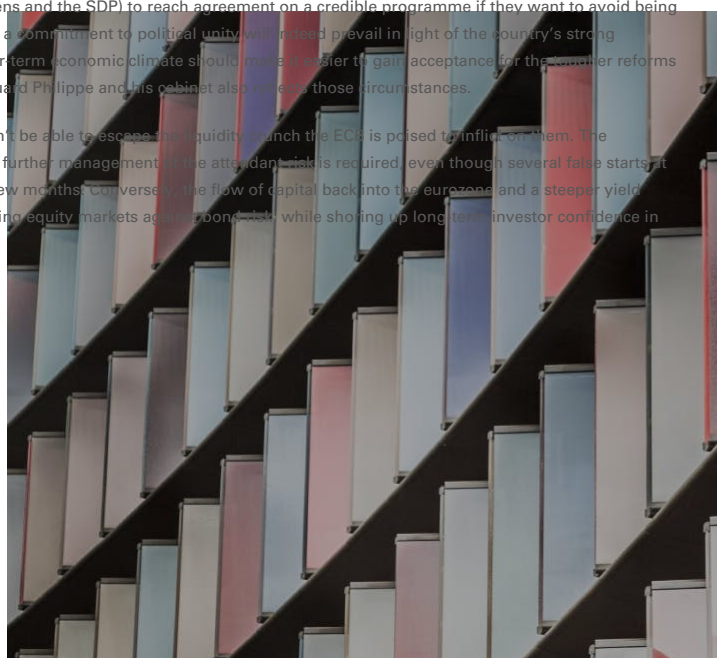
Source: Bloomberg, 29/9/2017

To be sure, the French elections in spring 2017 stemmed the spread of a corrosive trend towards political and economic fragmentation that had been threatening to sweep the eurozone since 2016. But Europe's democracies must still contend with serious voter frustration at both how little wealth the economy has generated in the past decade and how that wealth is divided up. Populism is virtually guaranteed to rear its ugly head during the next wave of elections in Europe – unless the reforms advocated by President Emmanuel Macron for the French economy and for eurozone governance as a whole are successfully adopted. Though Macron will need to overcome resistance to change at home, he can still steer implementation of his programme there to a large extent. On the other hand, he will have to convince Germany's coalition government – yet to be formed – that eurozone reform is imperative.

It is in the vital interests of Germany's moderate parties (the CDU-CSU, the FDP, the Greens and the SPD) to reach agreement on a credible programme if they want to avoid being ousted next time around by more extreme currents. And we can reasonably assume that a commitment to political unity will indeed prevail in light of the country's strong tradition of pursuing consensus (known as "Konsensdenken"). In France, the upbeat near-term economic climate should make it easier to gain acceptance for the tougher reforms on the agenda. The accelerated tempo of change adopted by French Prime Minister Edouard Philippe and his cabinet also reflects those circumstances.

With the current growth phase and renewed EU momentum, Europe's bond markets won't be able to escape the liquidity crunch the ECB is poised to inflict on them. The extraordinarily low yields on German government bonds will soon prove untenable, and further management of the attendant risk is required, even though several false starts at monetary policy normalisation have rendered the related hedges ineffective in the past few months. Conversely, the flow of capital back into the eurozone and a steeper yield curve may well initially heighten the positive role that cyclical expansion plays in protecting equity markets against bond risk while shoring up long-term investor confidence in the single currency.

Source: Bloomberg, 29/09/2017



Investment strategy

Equities

Stock markets fared well in September. Those in Europe were among the top performers, with gains in excess of 3%. A key factor here was a break in the single currency's previously uninterrupted bull run since the start of the year. At the same time, the oil industry was buoyed by a rebound of nearly 10% in crude prices during the month. Not only did that bring substantial gains to our Carmignac Portfolio Commodities fund; it also corroborated our forecast that oil prices would hold up and that the share prices of the US exploration and production companies in our portfolios would rise.

With the economic upswing soon to reach its peak, we have continued to beef up our positions in stocks with good visibility. We have also sought out companies whose growth potential is still undervalued by the market, many of them mid-caps. In addition, over the past month we have initiated positions in a Chinese operator of auto industry websites and a Swiss pharmaceutical company that makes iron deficiency drugs.

Fixed income

Sovereign bond yields in developed countries staged a modest recovery this past month, offsetting their retreat in August. Janet Yellen's assurances that the Fed would be forging ahead with monetary policy normalisation without waiting for inflation to hit the 2% target contributed to that trend. In the European sovereign bond space, the yield on Portuguese debt – our second biggest peripheral debt position after Italian paper – softened considerably after Standard & Poor's raised its rating to investment-grade. Emerging-market sovereign yields held steady by and large, and made a positive contribution to our Funds' performance through our carry trade strategy.

Also worthy of note are the rising premiums on high-yield European corporate bonds, which have prompted us to give greater weight to high-quality names. We are therefore sticking to our cautious approach to fixed income investment. That involves taking selective positions to capture yield on high-quality corporate issues and on government paper from emerging markets (e.g., Brazil and Russia) and the EU periphery (e.g., Italy and Portugal), while simultaneously shorting German sovereign debt to bring our overall duration down to nearly zero.

Currencies

The euro just experienced its first month of (extremely mild) decline against the US dollar since February. Since the beginning of the year, the single currency had corrected its undervaluation vis-à-vis the greenback, advancing to a level close to its purchasing power parity exchange rate and to its historic average since it was launched.

Any further appreciation will be dictated less by the euro's inherent value than by a change in its status as an international reserve currency. The euro's share of global currency reserves has fallen sharply since the sovereign debt crisis in the eurozone periphery, and we see potential for a rebound that should work to the long-term advantage of the single currency. That conviction has led us to retain the euro as our leading currency allocation.

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