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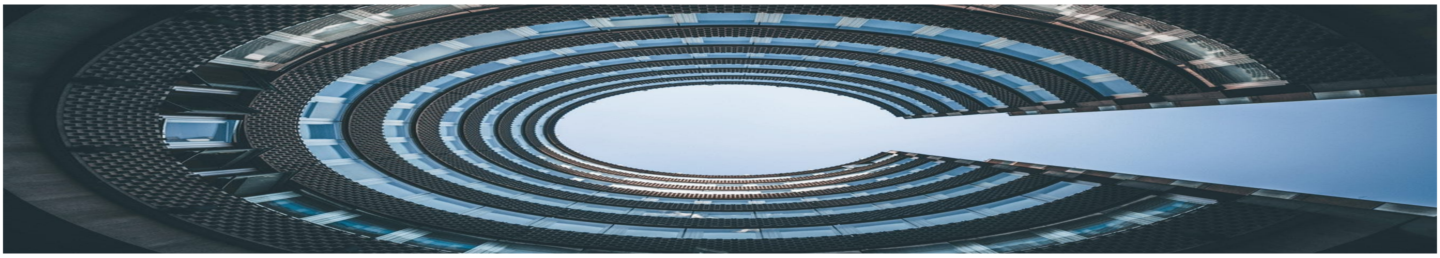

Our Monthly Investment Review : May 2022

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Concerns have shifted from inflation to growth

Asset prices picked up in May as investors looked optimistically at the more downbeat economic readings (especially in the US).

Stock markets ended the month more than 5% up from their monthly low, and the downwards pressure on bond prices eased. The yield on 10-year US Treasuries fell from 3.2% to 2.8%, and the credit risk premium slid from 4.9% to 4.2%.

The narrative among investors has indeed shifted in light of the many economic indicators – PMI readings, real-estate market data, and regional data, for example – pointing to a sharper-than-expected slowdown.

Until now, investors largely believed that central banks, and above all the US Federal Reserve, were concerned more about the brisk pace of inflation than the worsening economic outlook. But in view of May’s economic readings, they seem to be expecting the Fed to shift gears and carry out fewer rate hikes, as part of a less-aggressive approach to policy normalisation.

The spectre of stagflation

We believe this more optimistic stance – due in large part to overly pessimistic sentiment previously – should be taken with a grain of salt, and are therefore treading carefully.

The prices of some goods are still marching upwards, and retailers are having a hard time passing on the full increase in their own costs to consumers. At the same time, consumers are buying less. The nearly 20% tumble in the stock price of Walmart – the bastion of US mass-market retailing – in May is a clear reflection of these developments. And even though inflation isn't far from peaking in the US, consumer prices in Europe could keep rising until autumn.

All this means that the European Central Bank, after raising its policy rate as expected in July, could very well lift it by a further 50 bp later in the year. Such a prospect would create problems among the EU's 27 member states, given their different economic trajectories and the varying extent to which they're using public debt to finance stimulus programmes.

The days of central-bank "puts" are well behind us. These institutions can no longer serve as lenders of last resort and keep pumping liquidity into the system, given the inflationary forces at work (e.g. the reshoring of production plants, the energy transition, and changes in the structure of savings).

This is a real worry. Many speculative bubbles have formed as a result of the highly accommodative policies pursued around the world in the past few years. And in the past, nearly every switch to a cycle of rate hikes has caused such bubbles to burst and/or asset prices to plummet.

Managing our portfolios accordingly

Against this backdrop, we have maintained the approach to equities outlined in last month's investment report – that is, a low net exposure evolving between 5% and 15% with a preference for high-quality, defensive names. That's because earnings growth will probably slow as economic output cools and inflation stays high. We pared back our investments in the banking sector, for instance, and shored up those in healthcare and consumer staples.

We also increased our holdings of gold-related assets. These investments can help protect our portfolios should the economic downturn get worse, or should the US economy prove to be more resilient than expected – a development that would increase the chances of a sustained pace of policy normalisation by the Fed, with the possible consequence of a slump in financial markets.

In fixed income, we have covered nearly all our corporate-bond holdings through the use of index hedging, since we believe idiosyncratic risk (i.e. intrinsic to a specific company or country) offers better compensation than systemic risk. Our emerging-market holdings are geared towards bonds from countries that stand to benefit from the high commodities prices and the relocation of supply chains.

Cash still makes up a sizable chunk of our portfolios, which we believe makes sense in the current climate. This dry powder will let us seize market opportunities as they arise – opportunities that could later turn out to be performance drivers for our funds.

Sources: Carmignac, Bloomberg, 09/06/2022

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