Roads to nowhere

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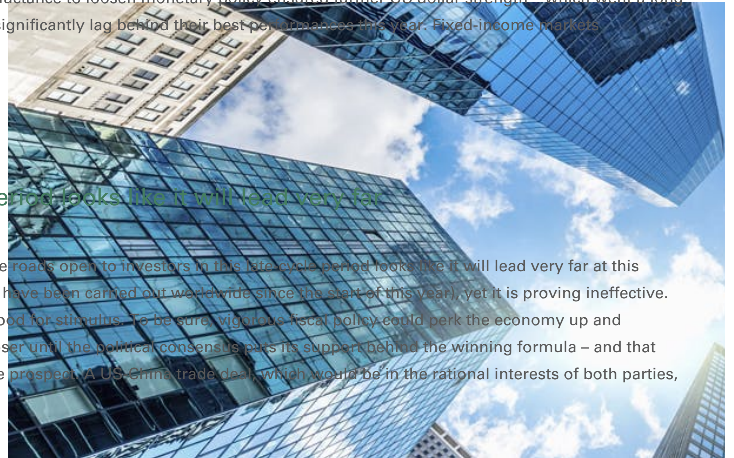
For the past five months now, it's consistently been the same story. Financial markets shunt back and forth between hopes for an imminent economic upswing – revived now and then by the prospect of a US-China trade deal – and the realisation that central banks are increasingly powerless to counter an economic slowdown they've lost control of.

In September, the European Central Bank's re-embrace of interventionist monetary policy and a few heartening glimmers on the trade-war front were enough to offset a good part of the damage done to stock markets by the contrary signals they had received in early August. However, with the Federal Reserve still in hesitation mode – as highlighted by the squeamish language it used to justify a modest 0.25% cut to its benchmark rate – and given the very limited traction the ECB has in financial markets, equity investors still had little cause to celebrate. Neither the Eurostoxx index, the S&P 500 or Japan's Nikkei index managed to end the third quarter substantially above the levels they had reached at end-April amid the widespread mood of relief in the early part of the year. Meanwhile, the Fed's reluctance to loosen monetary policy ensured further US dollar strength – which went a long way towards explaining why emerging-market equities continued to underperform and significantly lag behind their best performances this year. Fixed-income markets consolidated by and large, recovering from their capitulation in August.



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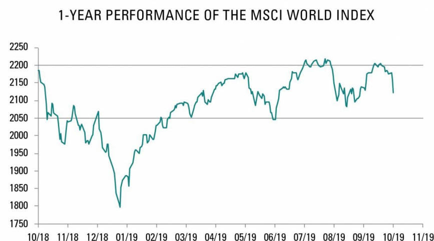
These financial-market behaviour patterns should come as no surprise today. None of the roads open to investors in this late-cycle period looks like it will lead very far at this point. Global monetary policy is already extremely dovish (a total of 43 interest-rate cuts have been carried out worldwide since the start of this year), yet it is proving ineffective. The Fed is still reluctant to take an openly accommodative stance, and Beijing is in no mood for stimulus. To be sure, vigorous fiscal policy could perk the economy up and emerge as the new frontier of macroeconomic hope. But that frontier won't loom any closer until the political consensus puts its support behind the winning formula – and that political process is too slow for financial markets. So that leaves markets mainly with one prospect. A US-China trade deal, which would be in the rational interests of both parties, is what is sustaining investors' hopes for a rally in these last months of 2019.

The current late-cycle phase is thus dragging on. As a result, equity indices continue to encompass broad price ranges, interest rates remain extremely low and, for the time being, the right strategy for both equity and fixed-income investors is still to seek out products offering maximum quality. Such an extreme focus admittedly entails an occasional risk of sudden but short-lived rebounds in cyclical names, as occurred in September. But even in today's highly unsettled political environment, the best way to beat the market is still a rigorous approach to picking securities across all asset classes with a focus on predictable earnings growth and moderate valuations.



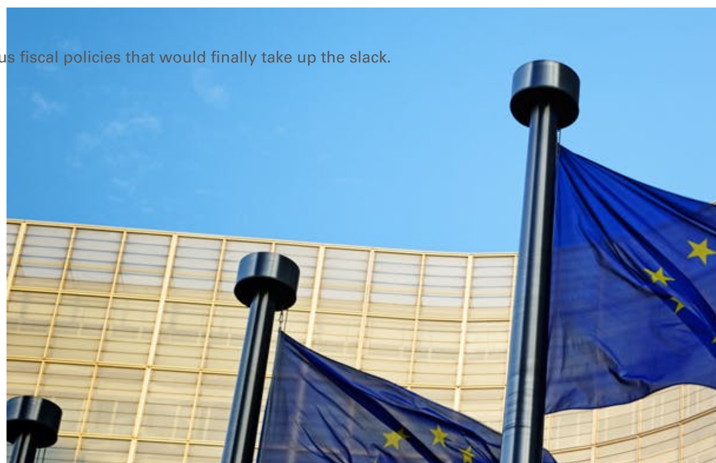
Source: Carmignac, Bloomberg, 02/10/2019

Now that we are entering the final quarter of 2019, it is time we started thinking about how markets might shape up next year. These past two years have seen a cyclical economic slowdown that is being compounded by long-term deflationary forces, heightened by deep-seated demographic and technological trends and made that much more dramatic by an unprecedented global debt pile. In 2018, financial markets first responded to a slowing economy with a serious sell-off, due to the oblivious attitude initially adopted by central banks. The latter subsequently made amends, with virtually all of them bringing down interest rates so much lower that equities staged a noteworthy comeback during the first four months of 2019.

But we shouldn't let this breather for the stock market distract us from the key issue: the real economy has become less responsive to interventionist monetary policy. It is increasingly clear today that central-bank action will no longer be enough to counter the global slowdown under way – particularly if widespread political uncertainty proves to be a lasting issue.

It follows that in contrast to 2019, 2020 could well be the year of a major turning-point for financial markets, as new ways forward will need to be considered by policymakers. If no convincing fix for central banks' increasingly evident powerlessness is found, a highly possible outcome would be a worsening macroeconomic situation – one with predictable consequences for risk assets. This prospect should not be the basis for an investor's core scenario at this stage, as it rests on the assumption that political leaders will be sleepwalking – whereas neither Donald Trump, nor the Fed or the Chinese and German governments have the slightest interest in letting a recession take hold in their countries. That said, this is no time for complacency either. After all, sleepwalkers with their eyes wide open merely create an illusion that they are awake and mindful. This wouldn't be the first time that major policy mistakes were made.

An alternative and presumably more upbeat scenario worth entertaining involves vigorous fiscal policies that would finally take up the slack.



In Europe, this scenario reflects the ECB's own viewpoint, and we may safely assume that the replacement of Mario Draghi by Christine Lagarde at the Bank's helm won't change that. In addition to greater public spending in Germany, the prospect for fiscal union in the eurozone – a prelude to a bona fide, substantial European budget – could at last make headway after being put off for so long as a result of German misgivings. Moreover, ECB support could more or less openly create the requisite conditions for a stimulus programme driven by greater government expenditure.

In the United States, a concrete gesture by Trump in the direction of a trade deal with China could give the economy a welcome boost, as it is now painfully clear that the political uncertainty stoked by this ongoing conflict has taken its toll on US corporate investment.

However, this upbeat scenario has at least one catch: the timetable. It assumes that policy decisions will be made proactively rather than to prop up severely weakened economies or to jump-start distressed financial markets. It also assumes that Beijing will be willing, if only out of necessity, to offer presidential candidate Trump "the high road" out of a negotiating stance predicated on the argument that the US can withstand a maximum of economic pain.

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But even if governments do finally resort to the fiscal stimulus weapon, we would be kidding ourselves if we expected that to peacefully restore financial markets to their "normal" state. On the contrary: after years of financial repression, the prospect of a radical shift in economic policy (possibly championed in the US by the Democratic hopeful Elizabeth Warren) would inevitably challenge the positioning of many investors, which tends to be quite extreme. Such a challenge would likely involve a sharp rise in volatility across all asset classes, currencies included.

It is important to keep in mind that the stock market rally in the first part of 2019, and the subsequent market consolidation under way for the past five months (which has been fuelled by steadily falling interest rates), were essentially a reprieve after the wake-up call that hit in 2018. The same market paradigm might continue into 2020 but would amount to a very precarious balancing act between the threat of recession and an outlook based on generous fiscal stimulus. That makes it sensible to start steeling ourselves now for a return to more directional investing, alongside the careful selection of securities.

Source: Bloomberg, 30/09/2019

Investment strategy

Equities

With trade tensions between China and the US subsiding once again and hopes reviving for fiscal stimulus policies, the first part of the month saw considerable sector rotation between defensive and cyclical stocks. The degree of that rotation was heightened by the extreme positioning of many investors who had long since turned their backs on the most cyclical segments of the market.

As dividend yields in many cases exceed the yields on core sovereign bonds, there is still fairly little risk of a sharp stock-market correction, and a constructive approach to equity exposure remains appropriate. However, our core portfolio still gives priority to maximum quality names. We feel they are poised for further outperformance in the current period of both structurally and cyclically low growth, while monetary policy is approaching the outer limit of what it can accomplish. But as those stocks have already gained a lot of ground, we continue to pay close attention to valuations. For example, though we have sold a large share of our holdings in the promising fintech sector, whose stock prices have done extremely well, we have also bought a stake in Square. This Silicon Valley-based company is a key provider of payment solutions for merchants like bakers, florists and coffee-shop owners. We have maintained our small, tactical exposure to European banks as a means to keep our portfolio balanced, since the European Central Bank expressed the desire in September to offset the damage being done to banks by its negative interest-rate policy.

Fixed income

ECB President Mario Draghi has announced a set of monetary easing measures, including rate cuts, the resumption of its asset purchase programme, less stringent parameters for Targeted Longer-Term Refinancing Operations (TLTROs) and tiered deposit rates for credit institutions. In the United States, Jerome Powell has lowered the Fed's benchmark rate by 0.25%, but still contests the idea that this marks the beginning of a genuine cycle of monetary policy easing. As those moves were to a large extent expected, yields on core sovereign bonds eased in September after hitting record highs in August. That consolidation was also fuelled by the hope that trade tensions between China and the US, which had sent shock waves in August, would soon subside. In response, we scaled back our modified duration, particularly in Europe, where yields had jumped to dizzying levels.

We are nonetheless sticking with our positioning geared to a flattening yield curve and converging spreads on non-core eurozone bonds, above all Italian and Greek. In the United States, the Fed is still under pressure to take a more dovish stance, not only to sustain a domestic economy that shows increasing signs of weakness, but also to deal with strains in the money market and a global economy still lacking in pep. We are therefore maintaining our constructive view of US Treasuries. In light of the stretched valuations of corporate bonds, we are continuing with our highly selective approach. We still hold subordinated bank bonds, an asset class that we expect to benefit from the introduction of tiered deposit rates by the ECB. In the emerging world, we have maintained limited holdings of Turkish debt denominated in strong currencies now that falling inflation is giving the country's Central Bank greater leeway.

Currencies

The changing interest-rate differential between the United States and Europe should have given the single currency a boost – yet the greenback has continued to appreciate against the euro. The Federal Reserve's members are apparently confident that their dovish turn will be short-lived, and that belief, along with a number of surprises in the US economy that have won approval from global investors, has kept the dollar strong. The greenback is caught between two contrary currents. On one side, it is being buoyed by the repatriation of funds from abroad by American investors and by a cash shortage in US money markets. On the other, the currency is overvalued and the country's twin deficits – trade and fiscal – are both still getting worse.

As we apparently have a less bullish verdict on the state of the US economy than the Fed and the financial markets do, we are maintaining our cautious stance on the dollar and hedging part of our dollar exposure arising from investments in US assets. We also believe that with elections coming up in the country, the debate over fiscal stimulus financed by additional debt – an approach favoured by several Democratic hopefuls – could rekindle investors' fears.

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