



The unrelenting law of evolution

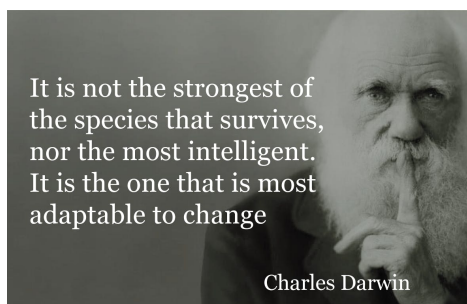


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As the summer draws to a close, there is still much uncertainty about how the pandemic will play out, because we know little as yet about the virus behind it. What we do know is that people, businesses and governments have started adapting to that uncertainty, however belatedly. The attendant changes in behaviour will make it difficult for the global economy to make much progress after the third-quarter recovery. They will, however, limit the chances of a major new surge in Covid-19 cases – and are already producing stark contrasts in performance between sectors.



In macroeconomic terms, deliberately shutting down 50% of the world economy a second time is no longer an option. Whatever happens, there will be a systematic preference for more targeted policies that can avoid another collapse in output. The period we are entering will thus be characterised by fragile, highly uneven global growth. Then again, the economy will keep getting fiscal and monetary life support from governments that will precede with the utmost caution in removing it.

Managing crises is every bit as crucial for investors as making sure they don't get the long-range implications wrong

In microeconomic terms, companies offering solutions to issues like mobility, health security and productivity are perfectly suited to this period. Their earnings have been rising since the beginning of the year. In contrast, other sectors are facing the stark choice between overhauling their business models or ceasing under. The law of evolution can by no means eliminate crises, but it can hopefully provide a helpful reminder that such crises tend if not to trigger, then to mitigate economic shocks, accelerate long-term trends.

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The pandemic is no longer the primary risk for financial markets

It is worth recalling that the epidemiological model produced early in the year by the highly respectable and esteemed Imperial College of London predicted that the coronavirus pandemic would cause as many as 2 million deaths in the United States and 500,000 in the United Kingdom. That model was apparently imperfect.

Whether under the influence of that grim outlook or because Western democracies felt it would be politically dangerous to go with a less drastic response to the outbreak than China, most of them opted for a large-scale lockdown, leading to the economic slump we experienced. Today, six months down the road, the world has resigned itself to trying to live with the virus. That means that, until an effective vaccine is discovered, tested, manufactured and distributed on a large scale, the threat will be with us. And it will affect behaviour, if only indirectly. As even widespread use of face masks won't entirely eliminate the possibility of infection, the number of new cases recorded will increase as testing ramps up and young people become a bit more careless – though this is unlikely to bring about a serious spike in fatality rates.

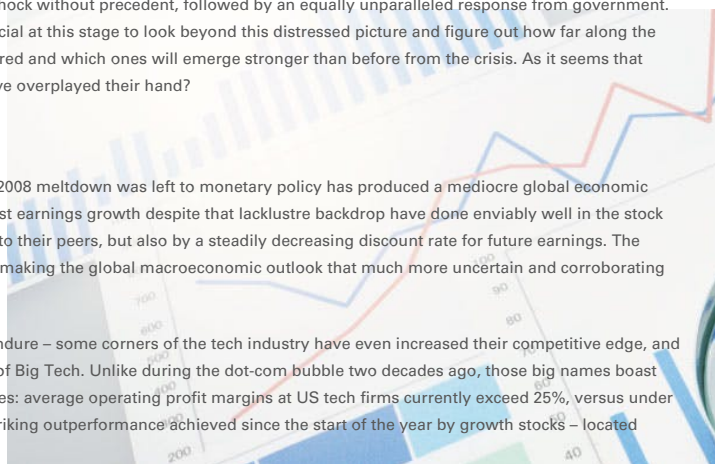
Hotel, restaurant and transportation businesses will make it out of the inferno, but with a heavy limp, and the banking industry will need to cut costs to stay afloat. Conversely, the use of e-commerce, videoconferencing platforms – now universally acknowledged as effective corporate communication vehicles – and Web-based solutions will continue to gain ground, albeit with more gradual uptake rates.

During the first half of the year, financial markets were forced to adjust to an economic shock without precedent, followed by an equally unparalleled response from government. Effective risk management proved crucial to preventing disaster. But it is every bit as crucial at this stage to look beyond this distressed picture and figure out how far along the various adaptation strategies have made it, as this can tell us which species are endangered and which ones will emerge stronger than before from the crisis. As it seems that investors have basically figured this out, is there good reason to worry that they may have overplayed their hand?

Have growth stocks become a source of danger?

Over the past decade at least, the fact that the whole job of treating the aftermath of the 2008 meltdown was left to monetary policy has produced a mediocre global economic recovery and a historic fall in interest rates. As a result, companies able to generate robust earnings growth despite that lacklustre backdrop have done envitably well in the stock market. Their share prices have been buoyed not only by a stronger bottom line relative to their peers, but also by a steadily decreasing discount rate for future earnings. The economic earthquake in the first half of 2020 has given an automatic boost to that trend, making the global macroeconomic outlook that much more uncertain and corroborating the view that interest rates will stay rock-bottom far into the future.

In today's unwonted climate of acute concern over health security – a concern likely to endure – some corners of the tech industry have even increased their competitive edge, and the surge in average corporate debt levels has shown a spotlight on the financial health of Big Tech. Unlike during the dot-com bubble two decades ago, those big names boast extremely robust balance sheets and much higher profitability than other listed companies: average operating profit margins at US tech firms currently exceed 25%, versus under 10% for the wider S&P 500, excluding tech and financial stocks. This suggests that the striking outperformance achieved since the start of the year by growth stocks – located mainly but not solely in the tech sector – is justified.



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Is that outperformance overblown? Not in our view. For example, the P/E ratio for companies in the MSCI World Information Technology Index currently offers a roughly 30% premium over the MSCI World Index. That's barely above the historic average for the past 25 years (a 25% premium) and infinitely lower than the 120% premium at which tech stocks traded in 1999–2000. Or consider this other, very instructive point. The ratio of price to forecast long-term earnings growth is now about the same for the famous GAFAM stocks (between 2 and 2.5) as for the rest of the S&P 500 – which was far from true twenty years ago, when investors were willing to be pay much less for expected future growth at non-tech firms.

The current market's fairly indiscriminating attitude towards valuation of growth stocks today is essential for two reasons. First, it shows that the tech sector is not overvalued once you take long-term growth potential into consideration. Second, this gives active fund managers an opportunity to offer major added value. In view of the present macroeconomic uncertainty, it's hard to arrive at long-range estimates that deserve much confidence. Only in-depth knowledge and analysis of each company, its competitive environment, the disruptive technology affecting its business model and a slew of other factors can make that possible. The growing influence of passive management styles and the role played lately by online trading platforms for US retail investors in driving specific stocks to meteoric levels have created more and more valuation anomalies – and with them opportunities for an active investment approach that stands out from the crowd.

Given both the nature of the 2020 economic crisis and how it has been dealt with, it would be presumptuous to claim we can predict how it will pan out. After all, who knows whether the extraordinary government support provided to companies and consumers will be extended for long enough to prevent a sharp rise in bankruptcy rates (particularly at medium-sized enterprises), which could well throw the economy back into a slump in 2021? This question is relevant to both Europe and the United States, and adds to the mounting uncertainty surrounding the US presidential election in two months. On the other hand, we might see a breakthrough in the treatment or prevention of Covid-19, or a move by central banks to cross the Rubicon – by fully and avowedly monetising the unprecedented fiscal deficits building up – or at least part of today's record household savings flow into the real economy. If all those boxes get ticked, if only temporarily, they could fuel the hope that we will ultimately emerge from ten years of macroeconomic lethargy and rock-bottom inflation expectations. This highlights the need to stand ready to act flexibly once again if necessary, because the law of evolution applies to everyone – starting with asset managers. In the meantime, the overriding imperative will be to construct equity portfolios composed, stock after stock, of names reflecting long-term convictions. For reasons of overall balance, those portfolios should also include assets with a connection to economic stimulus programmes such as corporate credit, as well as to their offshoots (e.g., fiscal deficits and an expanding money supply) like gold miners.

Investment strategy

Equities

Investors spent the summer reaching further for growth, putting their money in the sector offering the brightest earnings prospects: broadly speaking, the tech industry. Rising prices for secular growth stocks thus continued to sustain the returns on our equity strategy over the period.

However, recent tech valuations have rightly left many an investor wondering. In shaping our equity portfolios, we constantly keep an eye out for any signs of “bubble danger”. To start with, we regularly take profits on top contributors to performance such as fintech and e-commerce names. In addition, we stay true to our investment philosophy, based on the assumption that a share price already reflects all the publicly available information. We therefore invest solely in companies for which we are in a position to develop an investment case that differs from the consensus view. Though that philosophy may mean we miss out on a few short-term opportunities, it has amply stood the test of time. Last of all, our exposure to growth stocks remains diversified in terms of the regions, sectors and companies selected. On the whole, however, we still feel that tech companies deserve a premium. They possess a unique ability to grow their earnings whatever the stage in the business cycle, due to the secular trends that underpin their growth. Throughout the current crisis, they have amply demonstrated their defensive advantages. This goes not only for the new leaders in the advertising field, Google and Facebook, but also for Salesforce, which has shown that, despite declining overall capital spending, companies have continued to invest in digital. The low-rate environment created by central bank policy is offering those names additional support. However, we can't at this stage rule out short-term reflationary pressure in the event that an effective vaccine gets discovered, the macroeconomic outlook improves or inflation expectations pick up. We are accordingly maintaining our exposure to gold stocks, as they would gain ground if inflation expectations revived, and to a number of more cyclical companies.

Fixed income

Corporate credit continued to do well over the summer, whereas “core” government bonds had something of a bumpy ride. We see several reasons for this: there has been record issuance; the Federal Reserve now regards 2% as a long-term “average inflation target” rather than as an upper bound as previously; the macroeconomic numbers are looking better; and there is hope for an upcoming vaccine. We have therefore maintained fairly low duration in our fixed income portfolio.

We don't believe that duration will be much of a performance driver in Europe, as the recent unity shown by eurozone members represents a major departure from their approach to previous crises. The currency bloc's political response to Covid-19 has particularly helped government bonds from the eurozone periphery. With 10-year paper offering a spread of around 140 basis points, Italian sovereigns remain a source of yield in an environment of extremely low interest rates and abundant liquidity.

In US Treasuries, we are holding onto our position in 30-year bonds for now with the aim of taking advantage of a diminishing spread between the United States and Germany. Lastly, in emerging-market sovereigns, we are still selectively invested in countries like Romania and Mexico.

We still see attractive risk/return profiles in the credit market. Our exposure focuses as before on three key themes: quality issuers hurt by unfair spreads; financials; and companies affected by the Covid-19 slump, particularly in the tourism industry.

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