

VARIATIONS ON THE BALANCE THEME

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From our current vantage point halfway through 2019, we still see no valid reason to alter the basic view of financial markets we put forward at the close of the first quarter – despite the many dramatic political and geopolitical developments unfolding. The title of our March Note, “[Augmented Reality](#)”, referred to the reality of a slowdown in the world economy that was being mitigated by a shift in monetary policy towards out-and-out support for economic activity and financial markets, in contrast to the policies pursued in 2018. Since then, the trade-war saga (see our June Note, “[Trump or mercantilism 3.0](#)”) has done little other than to spice up an overall business climate whose consequences for equity markets remain fairly benign (see our April Note, “[A return to greater balance](#)”).

Equity indices performed moderately well in the second quarter: not a single major stock market, even in the US, has strayed more than 4% from its level at the end of March. The renewed acceleration of the falling bond-yield trend has given wings to share prices, which had previously been hurt by mounting uncertainty. In this late-cycle period, it is important to maintain our disciplined market analysis so that we can continue to distinguish between noise and signal.

1-YEAR PERFORMANCE OF GLOBAL EQUITY MARKETS (MXWO INDEX IN DOLLAR)



Source: Carmignac, Bloomberg, 29/06/2019

The routine cliffhangers in this year's serial drama



With the global economy on the wane, the US and China will be more inclined to be cautious about confrontation

As one could reasonably hope, the key takeaway from the talks between Donald Trump and Xi Jinping at the G20 summit in late June is that neither China nor the United States is particularly keen on throwing the world economy into a deep slump. This suggests that as both sides go on blowing hot and cold in the coming months – and the breeze this time in Osaka was rather mild – they will be influenced not only by their underlying strategic rivalry, but also by the US election timetable and a global economy on the wane. Both governments will therefore be inclined in the short run to be cautious about confrontation.

Meanwhile, the economy is sputtering

Wherever you look today, you see a lacklustre economic backdrop, with industrial production stuck in the doghouse – although the traditionally less cyclical service sector still seems resilient. China is a case in point.

At 49.4, the June manufacturing PMI survey released just after the G20 event confirms the downward trend. Nor does Beijing appear to be in the mood for a new stimulus programme at this juncture. In the United States, the growth rate for private non-residential fixed investment has continued to fall, no doubt as a result of uncertainty over trade. Europe's service sector indicators seem to be perking up a bit (for example, the Markit Services PMI for France rose from 51.6 to 53 in June), but the downtrend in manufacturing shows only tentative signs of levelling off, as in Germany, where the Markit Manufacturing PMI inched up from 44.3 in May to 45 in June. Oddly enough, however, this basically downbeat climate is good news for markets in the short term. Indeed, the outlook for low but relatively steady GDP growth temporarily limits the risk of trade-war escalation between China and the US and also ensures that central banks will hew to an accommodating stance, without lapsing into panic mode for the time being.

Is central-bank power on the way out?



In the medium term, the need to resort to greater fiscal spending is increasingly acknowledged

It's tricky business attaching relative weights to the various drivers of deceleration in the global economy: 1/ the slowdown deliberately engineered by Beijing in 2018; 2/ the detrimental impact of the US-China trade war on capital spending; and 3/ the untimely monetary policy tightening carried out last year. Due to its unclear proportions, this cocktail invites a key question. Will the return to dovish monetary policies currently on the agenda of the leading central banks be enough to counteract all the causes of the economic slowdown, particularly if the pressure on the Chinese economy holds up?

This shouldn't matter much in the short run, as the financial markets will probably feel comfortable with central bankers' renewed interventionism in what looks for now like a settled economic and political climate.

But in the medium term, the issue will be crucial, because unconventional monetary policy is plainly on its last legs. Consider the eurozone. What benefits can we expect to derive from a new bond-buying programme or a cut in key interest rates, given that France is already borrowing at negative rates on maturities up to ten years and that the yield on Spain's ten-year bonds is just 0.2%? So even with very high debt loads to contend with, there is growing recognition in Europe and the United States of the need to resort to greater fiscal spending – in coordination with support from central bankers. The sense that such political connivance will be unavoidable may help understand – or even justify – the appointment of central bank presidents possessing more of a legal background and demonstrated political savvy than expertise in the technicalities of monetary policy. And yet one has to wonder how this major shift will eventually impact bond and equity markets that have seen nothing other than financial repression and fiscal austerity for the past ten years.

The most sensible investment strategy at this stage of the business cycle still has the same three basic

components. The first one is a core equity portfolio focused on carefully selected growth stocks, given that they now constitute a pricy market segment. The second component is sufficient agility to be able to capture the upside potential of the intermediate market movements that are inherent in such transitional phases – and that are amplified by public postures reflecting domestic political agendas. Occasional, but highly disciplined use of option contracts makes it easier to avoid getting wrongfooted by the resulting ebb and flow of hope and disappointment. The third and last component relates to fixed income, through positioning along the yield curve to exploit the greater clarity today on policy easing by central banks. A disciplined approach in this case involves staying away from irrational negative yields and focusing instead on government and corporate bonds from developed and emerging economies that adequately reward risk.

Investment strategy

Equities

Powered by expectations of the Fed's reversion to dovish policies, equities enjoyed their strongest month of June in years. The S&P 500 gained nearly 7% in dollars, amply offsetting the correction it recorded in May. The stock market reflects a consistently fragile but positive balance with the state of the world economy, whose rate of expansion seems to have steadied at a low pace as central banks assert their support for financial markets and trade-war concerns tend to subside.

With this backdrop in mind, we are maintaining a constructive level of equity exposure and plan to hunt down clearly identified pockets of value – assembling a core portfolio of names that can leverage today's major disruptive trends to keep growing, along with more tactical exposure to "laggards" in a number of cyclical segments like European banking and US industrials and to emerging market companies. We believe that things will start looking up for the latter as the dollar gradually stops appreciating and more encouraging news comes in from the trade-war front.

Let's return for a moment to the major disruptive trends at work. Now that the rate of growth in the number of new internet users appears to be tapering off, with 3.8 billion users worldwide, as investors we will be seeking out the most innovative businesses – those offering new usages and monetisation opportunities. Facebook is exemplary in that regard, with their drive to expand into e-commerce and their Instagram app, which should lead to faster monetisation.



Fixed income

The shift towards easing by the Fed and the ECB has continued to drive down sovereign yields. However, with bond valuations what they are today, we are taking a highly selective approach, focusing on market segments that are still attractive and on relative value strategies.

In the eurozone's core and "semi-core" government bond market, we have moved more heavily into longer-dated paper. For example, we are long semi-core countries like Belgium and France, while we have set up swaps in euros and taken short positions in German sovereign debt in order to cash in on narrowing spreads. In the United States, we remain positioned to take advantage of a steepening US yield curve, a strategy that is starting to pay off.

We have also kept our long-dated sovereigns from the eurozone periphery, chiefly from Italy (a tactical position), Greece and Cyprus. We have selectively stepped up our exposure to emerging market debt in response to a more favourable global economic environment, with a preference for bonds denominated in strong currencies. In our corporate credit portfolio, we favour idiosyncratic opportunities like Altice, Eurofins and Netflix, together with subordinated bonds issued by European banks.



Currencies

The appreciation of the US dollar that got going over a year ago should begin winding down. The greenback is likely to be affected by weaker economic fundamentals as the Federal Reserve strikes a more interventionist tone, trade war tensions abate and the country's trade and fiscal deficits both continue to swell.

This line of reasoning has led us to keep our currency risk low, with the result that we are overweight the euro and have only limited US dollar and yen exposure. However, the outlook for emerging-market currencies may soon be brighter in what is shaping up to be a more favourable political and monetary environment marked less by a rising dollar.

Source: Bloomberg, 3/7/2019

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